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by Kathryn Garnett
Here's your chance to find your way through the Social Security maze—from computing how much you will receive to deciding when to start taking benefits to the sticky issue of taxation.
▶ **For CPAs who advise clients on retirement planning or who are approaching retirement themselves.**

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35 | Going Forward With Reverse Mortgages
by Howard Godfrey and Edward Malmgren
Elderly homeowners often obtain supplementary retirement funds through reverse mortgages. Getting a reverse mortgage can be a great financial move, but caution is needed because in some circumstances it can be very expensive. Here's a guide through the pros and cons.
▶ **For CPAs who offer retirement planning services.**

On the Cover: Image by Matthias Kulka/zefa/Corbis

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The Auditing Standards Board released eight new auditing standards—SAS nos. 104–111—to provide guidance concerning the auditor's assessment of and response to the risks of material misstatement in a financial statement audit. The SASs are effective for audits of *nonissuers* for periods beginning on or after December 15, 2006.
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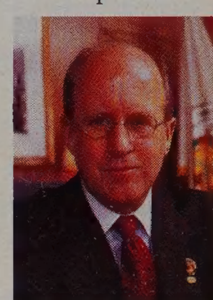
To assess its own effectiveness, Congress's watchdog agency obtained independent peer reviews of its financial and performance audits. The results are in: The reviewers recommended GAO procedures be used as better practices on a worldwide basis.
▶ **For CPAs involved with auditing and/or peer review.**



David M. Walker

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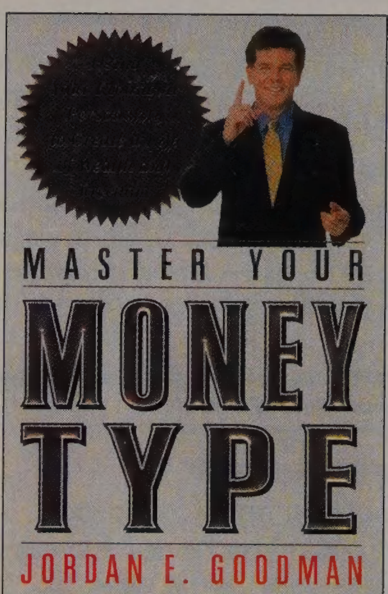
▶ For all CPAs.



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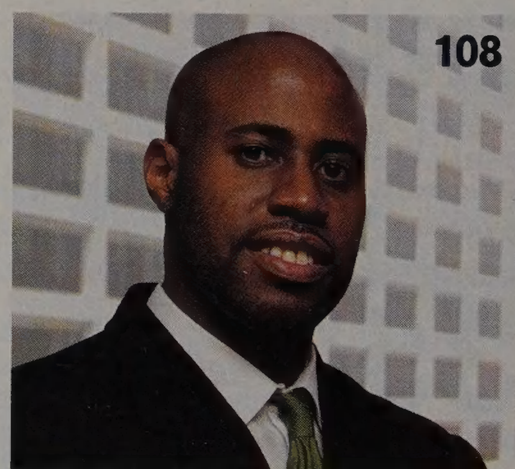

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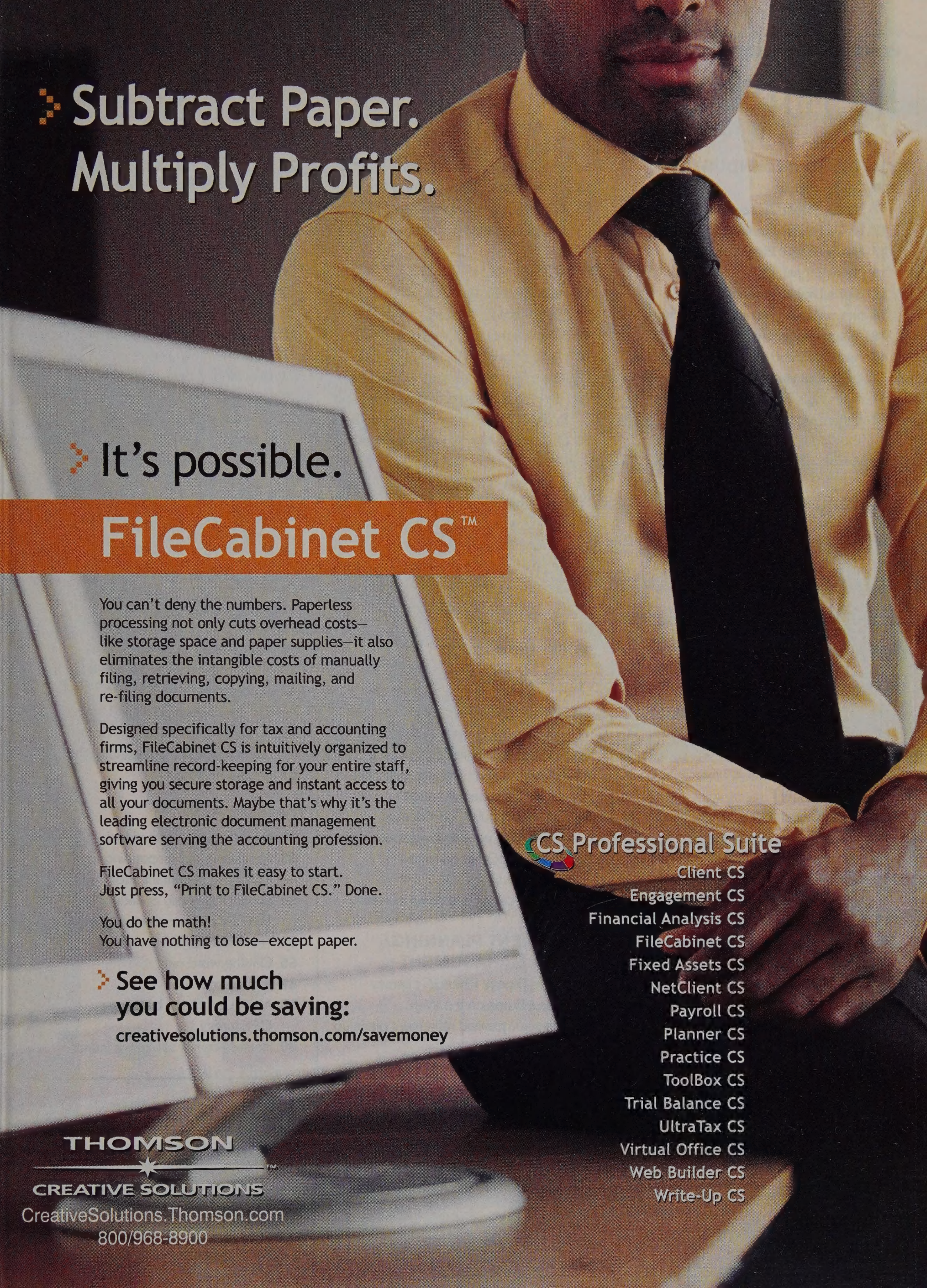
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HIGHLIGHTS

Committee to Address Interstate Practice Issues

The AICPA has created a volunteer Special Committee on Mobility to identify and address state mobility requirements that do not benefit the public, but block interstate practice by CPAs.

"To serve their clients and meet their own business needs, today's CPAs must be able to practice across state lines without unwarranted difficulty," said AICPA President and CEO Barry C. Melancon. "Unfortunately, that is not fully possible under the current substantial equivalency model for granting interstate practice privileges." The effectiveness of substantial equivalency, which the AICPA and the National Association of State Boards of Accountancy developed as part of the Uniform Accountancy Act, has been reduced because many states have modified the model.

"This is a high priority for the AICPA," said former Institute Chairman S. Scott Voynich, who heads the committee. "Although we're committed to state-based regulation, it's imperative to eliminate unnecessary barriers to interstate practice. We therefore expect to provide significant resources to states seeking to enact or revise mobility provisions within their accountancy laws or regulations, and we will, as necessary, support modifying the substantial equivalency model. Our goal is a system that facilitates CPAs' mobility and enables regulators to protect the public."

Tax Act Extends Certain Provisions

President George W. Bush signed the Tax Increase Prevention and Reconciliation Act of 2005 (HR 4297) into law in May. This legislation significantly extends several provisions affecting investors, employers and middle-income families—most notably, lower tax rates on capital gains and dividends and limits on the alternative minimum tax (AMT). Items in the new law

- Extend the 15% tax rate on capital gains and dividends and IRC section 179 expensing through 2010—increasing the accuracy of tax planning in these areas.
- Increase the AMT exemption level for 2006 to $62,550 for joint filers and $42,500 for single filers, and make permanent the temporary provision that allowed taxpayers to claim most nonrefundable personal tax credits against the AMT. These changes should slow the steady rise in the number of taxpayers subject to the AMT.
- Increase to 18 from 14 the age when the "kiddie tax" no longer applies. This significantly reduces the tax benefits of funding traditional Uniform Gifts to Minors Act savings accounts and of gifting income-producing investments to children. One alternative may be for gift-givers to invest in capital assets that appreciate or savings bonds that a custodian can hold until the minor reaches age 18.
- Require a payment of 20% at the time of application for an offer in compromise. This will make such offers a substantially less appealing way to reduce taxes owed to the IRS.
- Beginning in 2010, make rollovers to Roth IRAs from traditional IRAs available to higher-income individuals. Such a conversion may appeal to relatively young taxpayers who anticipate substantial capital appreciation in their investments before retirement, as well as to those who do not expect to need such funds until late in their retirement and thus are attracted to Roth IRAs, which do not require that distributions begin at age 70½. Because taxes on untaxed income transferred into a Roth IRA are due when the account is established, taxpayers planning such a conversion can either accumulate savings to pay the taxes at the time of conversion or satisfy them over a period of up to two years. And, assuming Congress doesn't change the new law, it may be beneficial for taxpayers to make nondeductible IRA contributions now and, if they are eligible, convert their traditional 401(k)s into rollover IRAs, thereby increasing the amount they can transfer to a Roth IRA.
- Index the foreign earned-income exclusion for inflation. But the law also hurts higher-income overseas workers by severely limiting the exclusion of housing costs.

Federal legislators followed AICPA recommendations by excluding certain provisions from the law, including the "more likely than not" standard for penalties imposed on preparers for positions taken on a return, the codification of the "economic substance" doctrine and "certification" of unrelated business income for certain exempt organizations.

More information is available at the AICPA Tax Center (**http://tax.aicpa.org/Resources/Tax+Advocacy+for+Members/Tax+Legislation+and+Policy**).

AICPA, FASB Seek Feedback on Nonissuer Standards Proposal

The AICPA and the Financial Accounting Standards Board are seeking comments on a joint proposal that explores the concept of financial reporting standards for privately held companies. The document outlines suggested process changes at FASB to ensure that the needs of constituents of nonissuer financial reporting are met. The proposal also calls for setting up a committee—jointly funded and sponsored by the two organizations—to review existing and prospective generally accepted accounting principles (GAAP) for their relevance and cost/benefit to the private company arena. The proposal can be found online at **www.pcfr.org**. The comment period ends August 15, 2006.

topline

News, People, Trends and Other Noteworthy Items

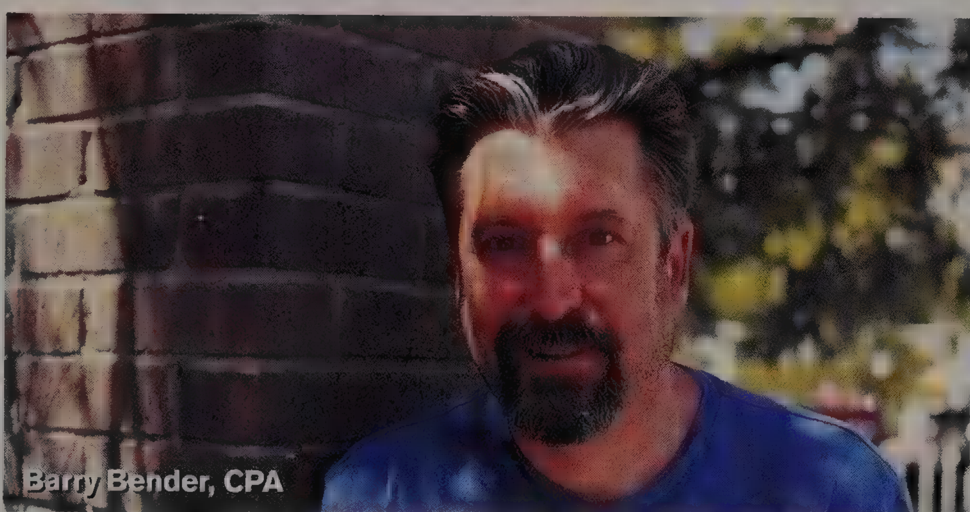
AS QUOTED

"The verdict makes clear that high-level corporate executives who deceive the investing public for personal gain will be held fully accountable."
—SEC Chairman Christopher Cox, on the Enron verdict

SPOTLIGHT

One Sax-y CPA

It's a well-known fact that children who are talented in music also tend to be great in math. So Barry Bender surely is not the only CPA who has two master's degrees, one in music and one in accounting. This March he got the opportunity to work on both of his favorite subjects, as he split his time between finishing up clients' tax returns and fulfilling his dream of producing and releasing an album of his own.



Barry Bender, CPA

Like fellow musical CPA Kenny G, Bender considers himself a saxophone player—though he also plays keyboard, guitar, bass and drums when he's not teaching accounting and business at Rowan University and Richard Stockton College in New Jersey. And while "Life (and Jade)" has not yet made it to the top of the charts, Bender isn't looking for fame. He's donating all proceeds from the album ($12 each at **www.barrybender.com**) to the Leukemia and Lymphoma Society in honor of a stricken friend.

"As an accountant I know that if I factor in all the courses I've taken and the instruments I've bought"—not to mention the full recording studio in his basement—"music is not a money-making proposition. I definitely have a debit balance in my music equity account," he says. "But for me, it's about being creative and having fun."

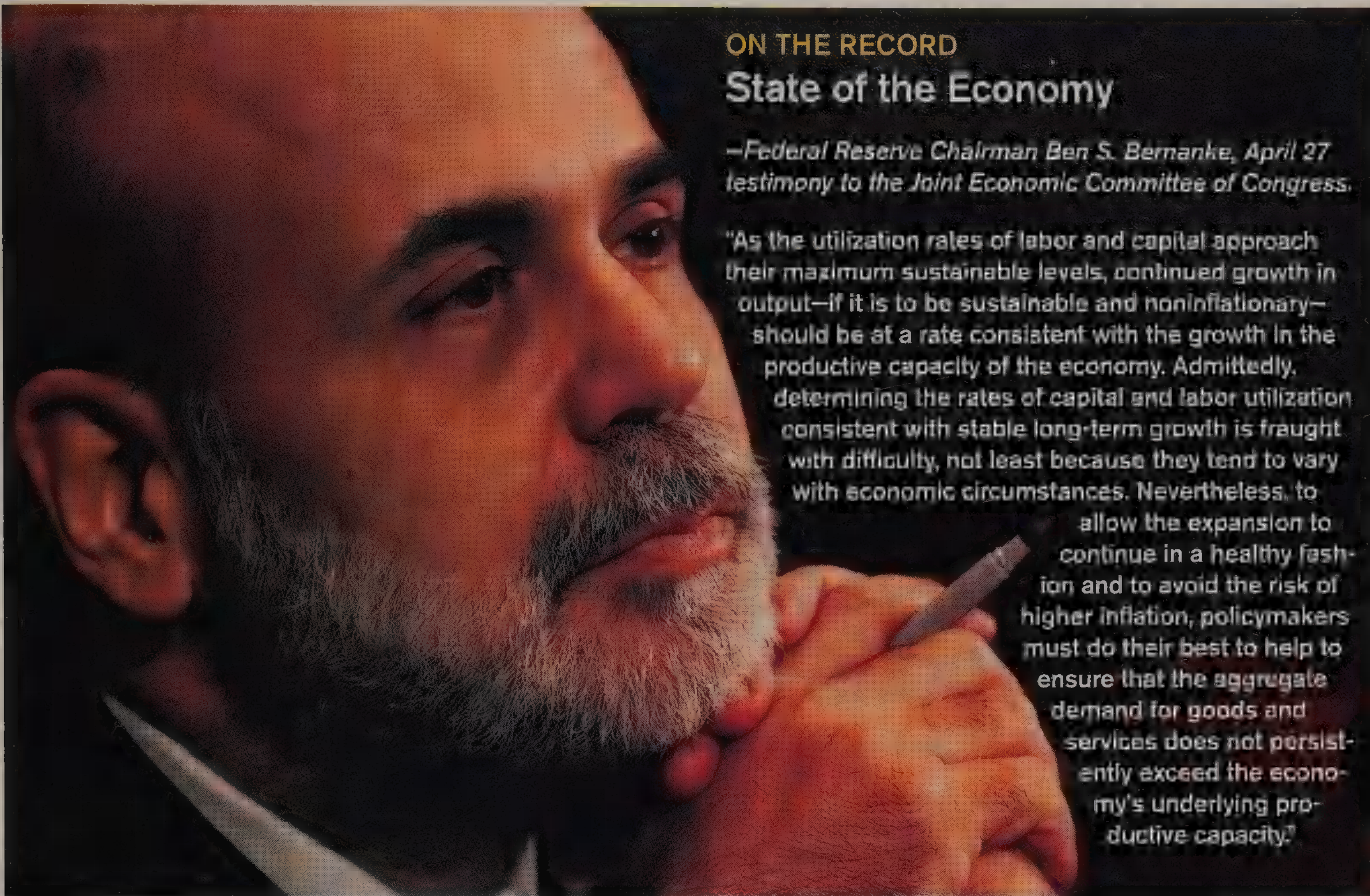
—Cheryl Rosen

CONSUMER ALERT

Spending Goes Up When You Can Charge That Soda

No longer just for big spenders, credit cards more and more are being used for small purchases such as sodas, pretzels and candy bars. Two years ago cashless transactions were introduced at fast-food restaurants; now such "microtransactions" are hitting the Coke machines. But consumers beware: A survey by USA Technologies (**www.usatech.com**) revealed people spent 50% more at vending machines when they could pull out a credit card instead of digging for change.

The average credit card purchase ($2.33) from vending machines at airports, train stations and roadside rest areas was 52% higher than the average cash purchase ($1.53). At theme parks, zoos, museums and theatres, the average purchase using a card was $3.29 compared with $1.81 using cash (an increase of 82%). In office buildings the average vending machine purchase rose to more than $1.00 (an increase of 28% over a cash transaction) when it was charged.



ON THE RECORD

State of the Economy

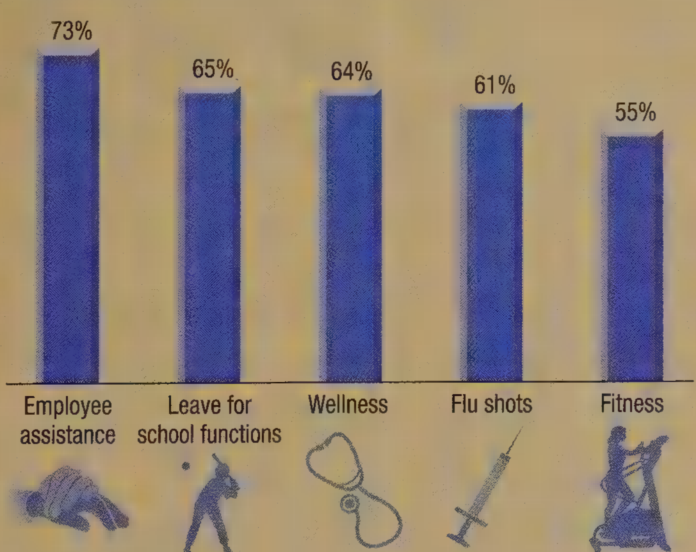
—Federal Reserve Chairman Ben S. Bernanke, April 27 testimony to the Joint Economic Committee of Congress.

"As the utilization rates of labor and capital approach their maximum sustainable levels, continued growth in output—if it is to be sustainable and noninflationary—should be at a rate consistent with the growth in the productive capacity of the economy. Admittedly, determining the rates of capital and labor utilization consistent with stable long-term growth is fraught with difficulty, not least because they tend to vary with economic circumstances. Nevertheless, to allow the expansion to continue in a healthy fashion and to avoid the risk of higher inflation, policymakers must do their best to help to ensure that the aggregate demand for goods and services does not persistently exceed the economy's underlying productive capacity."

SIGN OF THE TIMES

Striking a Balance

U.S. companies are recognizing how important it is to help employees manage their lives. The "CCH Unscheduled Absence Survey" found corporations offered an average of nine work/life programs in 2005, up from eight in 2004 and seven in 2003. The most common were these:



NUMEROLOGY

Five Tips for Safe Job Searches

Don't get hooked by scamsters "phishing" for your personal information through help-wanted e-mails.

1 Always proceed with caution when you receive a cold-contact e-mail from someone purporting to be a recruiter. Instead of clicking on the e-mail link, go to the company's Web site directly to verify its legitimacy.

2 Avoid responding to any requests for personal information such as your Social Security or credit card number.

3 When dealing with a resume writing or submission service, ensure information is encrypted before hitting the "submit" button. Encrypted Web sites either begin with the root URL "https" or have a padlock icon that appears in the bottom right corner of your screen.

4 Read and understand the privacy policy of the Web sites you patronize.

5 Report anything suspicious to the Internet Fraud Complaint Center (**www.ifccfbi.gov**).

Source: Resume to Referral, Springfield, Ohio, **www.resumebycprw.com**, 2006.

PHOTOGRAPH BY BROOKS KRAFT/CORBIS; CHART BY KAREN MINOT ILLUSTRATION

SURVEY SAVVY

Securing the Future

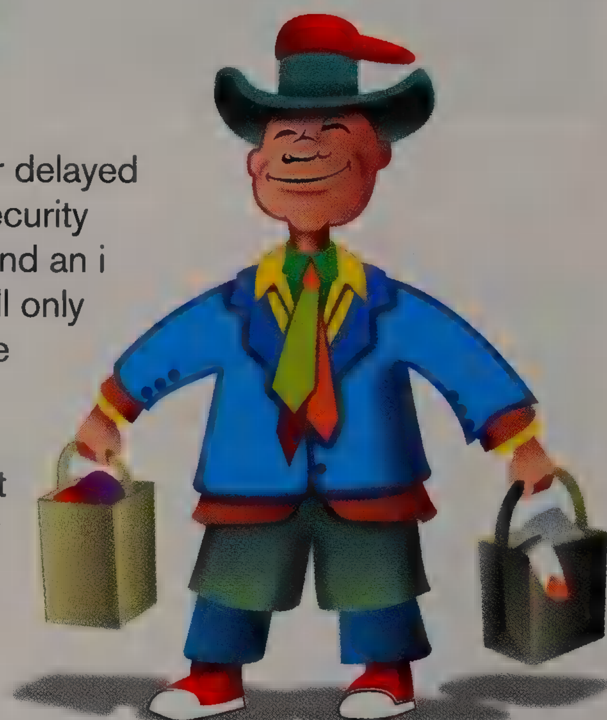
With retirement approaching, 26% of baby boomers expected to live very comfortably and others (29%) said they'd meet expenses with a little left over. The remaining 41% foresaw either *just* meeting their basic living expenses or not having enough even for that.

What retirement income were they all banking on? Almost half (49%) had 401(k) and IRA savings, and 40% are counting on Social Security or employer pension plans. The remaining 11% either had other savings or didn't know.

Source: Pew Research Center survey of 968 respondents, age 41 to 59, **http://pewresearch.org**, 2006.

GOLDEN BUSINESS IDEA

Singing the Lost Luggage Blues



How many of you business travelers have had lost or delayed luggage due to an airline snafu? With increased security regulations, airport congestion, tight connections and an increased volume of passengers and bags, the problem will only get worse. SITA, a global technology provider for the airline industry, says 30 million bags will be mishandled this year.

How can travelers minimize the problems of lost luggage? You can wear multiple layers of clothing or try to put everything into your carry-on bags and fit them into already jammed overhead bins. Or you can buy insurance. Travelers can find insurance plans to reimburse them for

- Lost or stolen baggage.
- Repair of damaged bags.
- The purchase of essential items if baggage is delayed.
- Accommodations and travel expenses if lost luggage results in delays of six hours or more.

When purchasing insurance to cover lost luggage and other travel perils, the U.S. Travel Insurance Association advises consumers to make sure the policy offers the protection they are seeking and to look for insurance companies that are members of the nonprofit group, as they have agreed to abide by a code of ethics and professional principles. The group's Web site, **www.travelinsurance.org**, lists companies that meet these standards.

Tip: On your outbound flight, add a paper luggage tag—available at airline ticket counters—with the address of your destination. If your luggage is lost or delayed on this leg of the trip, it may help you recover it faster.

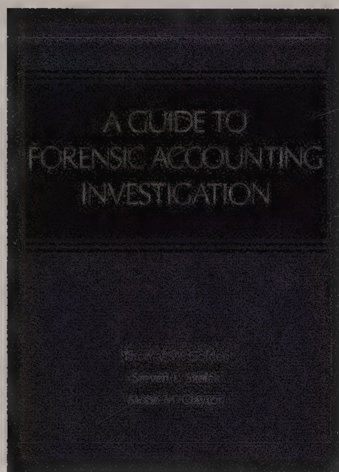
ILLUSTRATION BY NED SHAW

BOOKMARKS

A Guide to Forensic Accounting Investigation

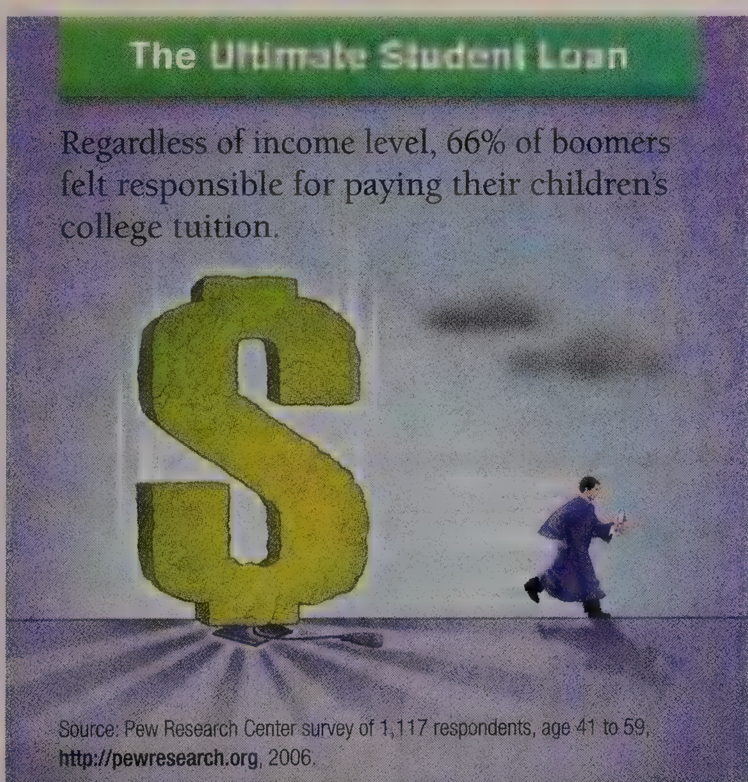
By Thomas W. Golden, Steven L. Skalak and Mona M. Clayton
576 pages; hardcover
John Wiley & Sons, 2006

In *A Guide to Forensic Accounting Investigation*, forensic accountants and auditors Thomas W. Golden, Steven L. Skalak and Mona M. Clayton explore what assurances auditors should provide in a post-Sarbanes-Oxley world. The book reveals the surprising complexity of fraud deterrence, detection and investigation, and offers a step-by-step approach to dealing with it. From basic techniques to intricate tests and technologies, this useful volume answers the need for wiser, better-trained financial statement and internal auditors who are thoroughly trained in fraud detection.



–Michael Hayes

NUMEROLOGY



KAREN MINOT ILLUSTRATION

DATA POINT

$105,000

The amount private organizations spend on corporate governance procedures per year—an increase of 26% over the pre-Sarbanes-Oxley tab.

Source: "The Impact of Sarbanes-Oxley on Private & Nonprofit Companies," Foley & Lardner LLP.

BUSINESS TIPS

Seven Ways Managers Can Keep Clients Front and Center

1 **Play "Follow the leader."** Managing partners set the tone for everything, good or bad, that takes place in the firm. It's important for leaders to keep their focus on the client rather than internal politics and ego gratification.

2 **Remind employees of their mission in the organization.** A quick daily meeting can set the tone of the workweek and be a source of inspiration in a firm of any size. A constant conversational reminder will ground employees in their primary cause in the firm.

3 **Shine a spotlight on staff.** Give employees the attention they deserve. Honor individuals who go above and beyond their job descriptions and truly delight clients. This sets the pace for others to follow.

4 **Invest in your staff.** Make sure they are consistently well-trained, motivated, mentored and equipped with the proper tools to serve clients.

5 **Realize that smart firms learn from their mistakes.** Be honest and open about why a specific aspect of client service failed. Mistakes are important because they lead to discussion and innovation. Managing partners must outline clear actions that will remove the causes of the organization's failures and then take steps to follow through.

6 **Form a focus group.** Bring together a small, carefully selected group of people to explore perceptions about a product or service your firm is offering, so you're more able to make well-thought-out decisions.

7 **Keep clients informed of improvements.** When you make a change or innovation, communicate it to clients. If clients don't realize there's been an improvement, there is no improvement.

Source: Adapted from *Becoming a Customer-Focused Organization* by Craig Cochran, Paton Press, 2006.

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ACCOUNTING

■ The AICPA issued four technical practice aids (TPAs) containing questions and answers related to FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*. The TPAs—1400.29, on consolidated versus combined financial statements; 1400.30, on standalone financial statements of a variable interest entity; 1400.31, on the effects of a GAAP departure; and 1500.06, on the interpretation's application to income tax basis financial statements—are available at **www.aicpa.org/download/acctstd/FIN_46_R_TPAs.pdf**.

AUDITING

■ The Public Company Accounting Oversight Board (PCAOB) said its 2006 inspections of firms that audit public companies will focus on whether they expended their efforts and resources efficiently in achieving the objectives described in PCAOB Auditing Standard no. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. This year nine firms—eight U.S. and one Canadian—that each audit more than 100 public companies will undergo inspection, along with selected smaller domestic and foreign firms that audit at least one public entity (**www.pcaobus.org/news_and_events/news/2006/05-01a.aspx**).

The board also issued two informational statements. One, an overview of Auditing Standard no. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, helps auditors understand and comply with the standard's required auditing procedures (**www.pcaobus.org/standards/standards_and_related_rules/as4/2006-04-27_2006-003_as4_summary.pdf**). The other is a series of answers to frequently asked questions about the accounting support fee certain public companies and mutual funds pay to fund the PCAOB's activities (**www.pcaobus.org/support_fees/supportfeefaq.pdf**). The fee applies only to equity issuers and investment-company issuers that during the prior calendar year had average monthly market capitalizations greater than $25 million and $250 million, respectively.

FINANCIAL LITERACY

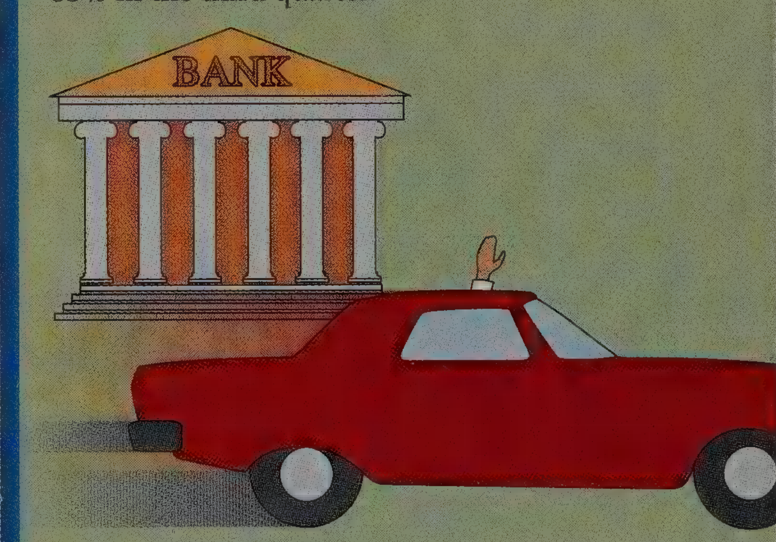
■ American companies can no longer afford to offer their employees adequate pensions, nearly three of four respondents (74%) said in an AICPA survey of CPAs serving as senior corporate executives (**www.aicpa.org/news/index.htm**). "This is a wake-up call," said AICPA business and industry vice-president John Morrow. "Employees will have to find other ways to finance their retirement." Fifty-nine percent of survey participants agreed, saying Americans will have to educate themselves about retirement savings strategies. To that end, the Web site of the AICPA's 360 Degrees of Financial Literacy campaign (**www.360financialliteracy.org**) offers hundreds of free tools and resources to help consumers

■ For single-click access to further coverage of the news stories listed here, visit the *Journal of Accountancy* Web site at **www.aicpa.org/pubs/jofa/joahome.htm**.

■ For news from the AICPA and state societies, visit **www.cpa2biz.com**, which also offers online CPE, AICPA professional literature, practice management aids and links to state society Web sites.

Going It Alone

In the fourth quarter of 2005, 87% of fast-growth companies did not take out a new bank loan, up from 83% in the third quarter.



Source: *Barometer Surveys*, PricewaterhouseCoopers, New York, **www.barometersurveys.com**, 2006.

CHART BY KELLEY GRAPHICS

better understand and manage their personal finances. Volunteer opportunities are available for qualified CPAs; go to **www.360financialliteracy.org/in+your+state** for information on how you can help members of your community reach their lifetime financial goals.

INTERNATIONAL

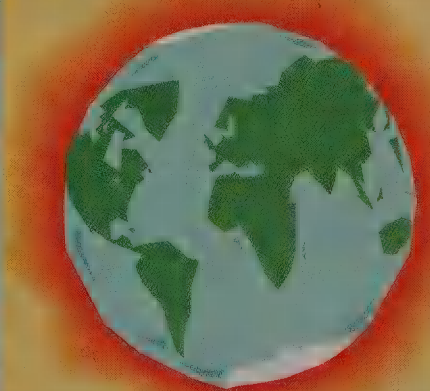
■ The International Accounting Standards Board (IASB) published a Statement of Best Practice, *Working Relationships between the IASB and Other Accounting Standard-Setters*, that identifies activities in which the IASB and similar national and regional bodies believe they should engage to facilitate the adoption of or convergence with international financial reporting standards (IFRSs). They include standard-setters' communicating among themselves and with their constituents; developing projects that help the IASB complete certain undertakings; commenting on IASB consultative documents, such as exposure drafts; and suggesting approaches to adopting or converging with, and helping develop interpretations of, IFRSs. The statement can be downloaded at **www.iasb.org/uploaded_files/documents/8_1500_SOBPFebruary2006final.pdf**.

■ The trustees of the International Accounting Standards Committee Foundation published a consultation document, *Due Process of the International Financial Reporting Interpretations Committee—Draft Handbook* (**www.iasb.org**). The foundation oversees the activities of the IASB and the International Financial Reporting Interpretations Committee (IFRIC). Comments are requested by September 30, 2006, on IFRIC's current structure and procedures, including its agenda committee, criteria for selecting agenda items, consultation regarding issues not added to the agenda and relationship with national standard-setters and interpretive groups.

■ The International Federation of Accountants published its *2006 Handbook of International Auditing, Assurance, and Ethics Pronouncements*, which includes all guidance issued by the International Auditing and Assurance Standards Board and the International Ethics Standards Board for Accountants through December 31, 2005. The code of ethics, which became effective June 30, 2006, applies to all professional accountants, whether in business and industry, public practice, the public sector or education. Print, CD and free electronic versions are available at **www.ifac.org/store**.

A Mutual Concern

Seven out of 10 U.S. mutual fund investors wanted the funds to screen for companies linked to global warming.



Source: Civil Society Institute, Newton Centre, Mass., **www.civilsocietyinstitute.org**, and Ceres, Boston, **www.ceres.org**, 2006.

MONEY LAUNDERING

■ The IRS, 33 states and Puerto Rico agreed to share Bank Secrecy Act (BSA) information and coordinate their resources to ensure that currency exchangers, check cashiers, money transmitters and issuers of traveler's checks and stored-value cards—known as money services businesses (MSBs)—register with the government and report cash transactions and suspicious activities that may be signs of money laundering or other financial crimes. Additional information about MSBs and the BSA is available at **www.irs.gov** or the Treasury Department's Financial Crimes Enforcement Network (**www.fincen.gov**).

FYI

■ Ray Whittington, CPA, a distinguished accounting educator, was appointed dean of DePaul University's College of Commerce and Kellstadt Graduate School of Business. Whittington joined DePaul's faculty in 1997. Previously, he served as director of auditing research at the AICPA and vice-chair of the Auditing Standards Board and was a senior auditor for KPMG Peat Marwick.

■ The IRS has appointed two practitioners to its Advisory Committee on Tax Exempt and Government Entities. Joan M. DiMarco, CPA, is the managing partner of the Philadelphia office of BondResource Partners LP, a firm specializing in tax-exempt bonds. Sandra Starnes, CPA, is cash management officer for the Port Gamble S'Klallam Tribe in the state of Washington.

■ Josh K. Jones and Sandie E. Kim began two-year terms as professional accounting fellows in the SEC's Office of the Chief Accountant. Both are senior managers—Jones in Ernst & Young LLP's Atlanta practice office and Kim in Deloitte & Touche LLP's national office accounting consultation group in San Francisco. They will develop rule proposals under federal securities laws, communicate with professional accounting and auditing standard-setting bodies and consult with SEC-registered companies on accounting and reporting matters.

■ Luther Bragg, CPA, was appointed to the Accounting and Auditing Policy Committee of the Federal Accounting Standards Advisory Board by Gregory H. Friedman, vice-chair of the President's Council on Integrity and Efficiency and inspector general of the U.S. Department of Energy. Bragg serves as the assistant auditor general for financial management and comptroller audits in the Department of the Navy's Office of the Auditor General. ❖

Correction

The Last Word column in May incorrectly cited the date Frank Bahl became CFO of Tax Technology Enterprises. Bahl was promoted to that position in 2000.

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NEW & NOTEWORTHY

Are You Independent?

New Practice Aid Helps You Comply with AICPA and GAO Independence Rules

by Catherine Allen, CPA

US auditor independence rules have undergone many significant changes in the last decade and the rules continue to evolve.

With rules covering many situations where independence might be impaired, from business relationships and services to fee arrangements and other relationships, it has become increasingly difficult for practitioners to keep up with the standards. A tool is needed to help practitioners comply with those standards. That's why the AICPA is offering a special new Practice Aid, *Independence Compliance: Checklists and Tools for Complying with AICPA and GAO Independence Requirements.*

This Practice Aid addresses two sets of auditor independence rules. The first is Rule 101, *Independence*, of the AICPA *Code of Professional Conduct* (the "Code") and its related rulings and interpretations.

This rule applies to all engagements requiring independence under AICPA Professional Standards.

Some examples are:

- Audits and reviews of financial statements
- Compilations of financial statements where the firm does not disclose a lack of independence
- Reports issued under Statements on Auditing Standards (SAS) No. 70
- Other attestation services such as Agreed Upon Procedures

The second set is the Government Accountability Office (GAO) independence rules, which apply to financial statement audits, attestation services and performance audits of government entities, programs and organizations receiving federal (and some state) funds, including profit and not-for-profit entities.

This Practice Aid provides you with comprehensive checklists, glossaries, illustrations and other guidance that walks you through the requirements of the independence rules and helps you comply with those important rules.

For information on *Independence Compliance: Checklists and Tools for Complying with AICPA and GAO Independence Requirements*, (No. 006627) log onto www.cpa2biz.com or call 1-888-777-7077

The Author: Catherine Allen is a consultant with Audit Conduct, through which she provides CPA firms, professional organizations and others with high-quality solutions to complex ethics, independence and compliance issues. Ms. Allen was a senior staff member of the AICPA Professional Ethics Executive Committee, the national offices of two of the "Big 4" accounting firms and an adjunct professor of accounting at the City University of New York.

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CPA/PFSs can find retirement planning advice here, including information on rolling over qualified plans, an IRA fact sheet and five reasons to open a 401(k) plan. Take a quiz to see how much you know about the basics of retirement planning, calculate 401(k) plan savings or sign up for a free newsletter.

WEALTH OF RESOURCES
www.fpanet.org

Free registration at the Financial Planning Association Web site gets planners access to a calculator that can figure the worth of your client's 401(k) at retirement. Find checklists on the documentation you should ask clients to supply to begin working with them and questions they may ask about your qualifications. Take an investment fraud awareness quiz or research what to do with your retirement plan if you lose your job.

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OLDER AND WISER
www.wiser.heinz.org

The Women's Institute for a Secure Retirement (WISER) Web site offers five things women need to do for retirement, as well as five reasons retirement is a challenge for female workers. You can find 10 ways baby boomer women can avoid retirement poverty, read up on issues related to retirement plans, such as divorce and widowhood, or see how well you do on a pension checklist.

RETIREMENT RESOURCES
www.wealthygeek.com

Don't let the tongue-in-cheek Web address fool you: CPAs looking for pertinent information on retirement planning for themselves and their clients will find it here. Links take users to Q&A discussions on factors affecting 401(k) plans, such as active vs. passive plan management and when payments kick in and tips on how to manage investment losses.

GENERAL INTEREST SITES

TAX TIPS
www.fixedassetinfo.com

Tax advisers can get articles here on how to capitalize costs for intangible assets or read up on recent legislation and official guidance on depreciation and amortization. From the Accounting Links section, go to a business glossary or postings of accounting jobs. The Tax Center has links to property-tax-filing deadlines, current-year tax forms and news from the IRS. Take a free online course in depreciation and get a certificate when you complete the follow-up tutorial.

TAX TIME
www.starkman.com

Atlanta CPA Jay Starkman's Web site offers tax resources, including a sample of his 2005 Tax Organizer—a dozen-page questionnaire for client tax information. CPAs can read the article "Tax Court Petition Filing by Nonattorneys" and brush up on these skills with practice Tax Court exams from 2002 back to 1977. Take a break with humorous tax stories, such as how clients should not handle an IRS audit and the tale of "The Cheap Millionaire."

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CPAs looking for historical or current information on corporate governance and regulation, the domestic and global economies or social policies can find it at the Brookings Institution e-home. At the business category in the Research Topics section, users can read news about corporate social responsibility, fraud and diversity as well as learn the "four pillars of high performance." Get articles on improving your retirement security in the U.S. Economics section.

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—*Vince Nolan*

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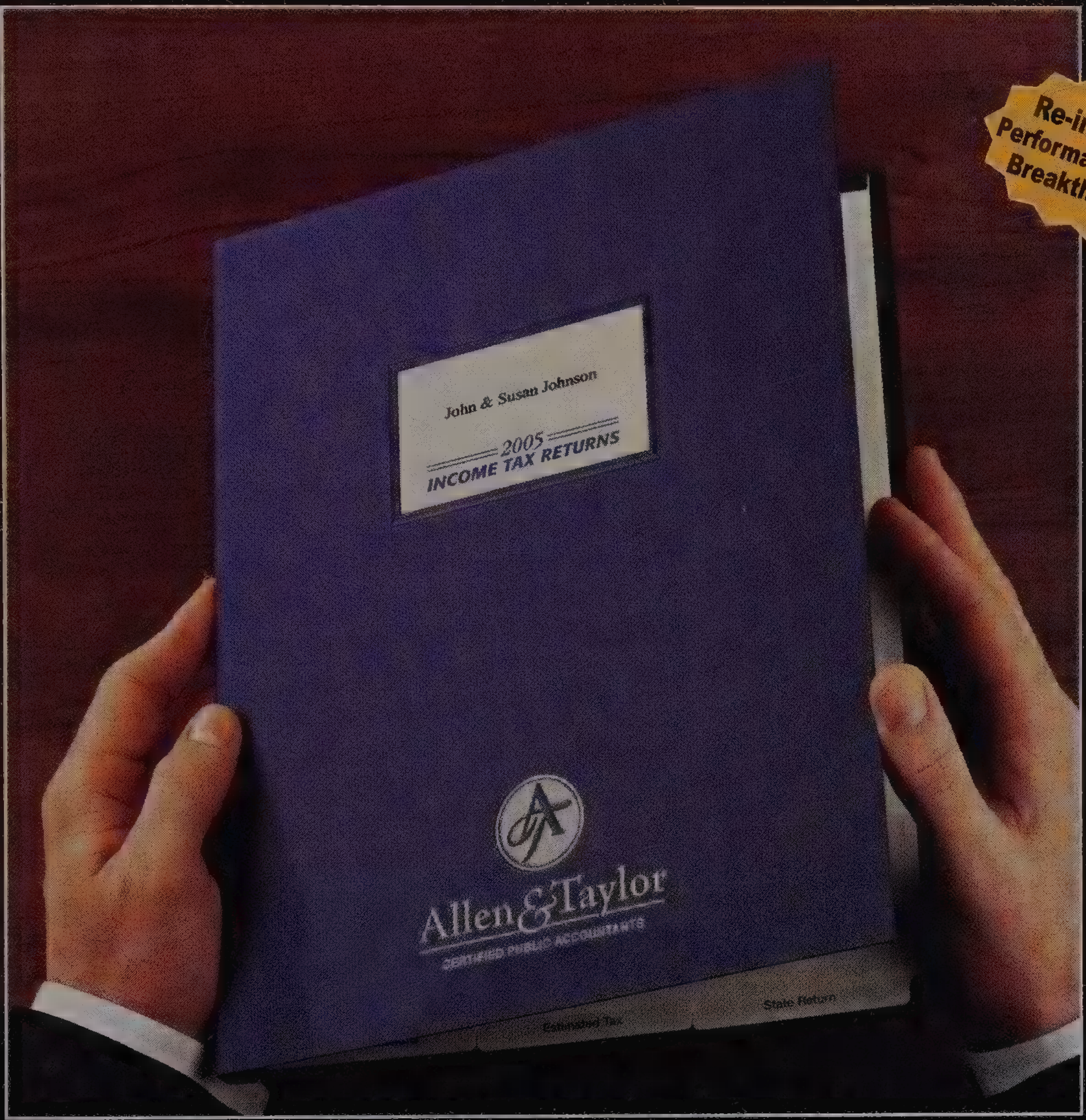

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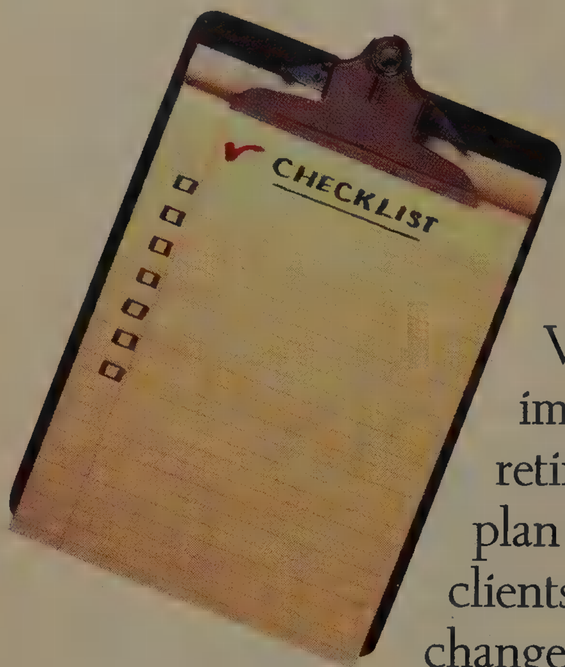

Are Your Qualified Retirement Plans Up to Date?

Various changes in tax law have had a positive impact on how much Americans can save in qualified retirement plans. By reviewing the different types of plan designs before the end of 2006, CPAs and their clients may be better able to capitalize on some of these changes. Here are some points to consider:

❑ ***Elective 401(k) deferrals.*** The maximum elective contribution per employee in the 2006 calendar year is $15,000, even if the plans are from different employers.

❑ ***Catch-up contributions.*** Employees who will reach age 50 or older by the end of the plan year can add a catch-up contribution of $5,000 to their 401(k) elective deferrals.

❑ ***Annual additions limit for defined contribution plans.*** Annual additions—including employer contributions, employee contributions and forfeitures—are limited to the lesser of 100% of compensation or $44,000. The catch-up contribution is not included in this limit.

❑ ***Annual compensation limit.*** The eligible compensation limit in 2006 was $220,000. If services are rendered by a husband and wife, consider balancing their compensation (as long as it is reasonable and customary) to increase their overall retirement contribution.

❑ ***Highly compensated employee limit.*** Employees earning $100,000 or more may be excluded from the plan. This may work well in a professional organization, which could cover non-highly-compensated employees along with the partners, leaving out highly-compensated managers or supervisors.

❑ ***Maximum annual retirement benefit.*** The annual limit for defined benefits is $175,000 for retirement ages 62–65.

❑ ***Tax credit for new plans.*** A three-year tax credit of 50% of the first $1,000 of start-up costs ($500 maximum) is available to employers with fewer than 100 employees that cover at least one non-highly-compensated employee. Eligible expenses include fees to establish the plan, administrative fees and costs incurred to educate employees about the plan.

❑ ***The Roth 401(k).*** A Roth 401(k) plan may be added to a traditional 401(k) plan, allowing participants to make after-tax contributions. Income limits do not apply. Employer matching contributions must continue to be made on a pre-tax basis. Plan sponsors must amend the plan to include the provision.

❑ ***One-person plans.*** Employee deferrals are not included in the deduction limit, though they are included in the annual addition limit. Consider a uni-401(k) plan or a defined benefit plan with a 401(k) to maximize contributions. For example, in 2006 a 50-year-old business owner earning $50,000 of W-2 compensation could contribute $32,500 to a uni-401(k) plan (25% × $50,000 = $12,500, plus $15,000 employee deferrals plus $5,000 catch-up for age 50). The same business owner making $220,000 could contribute only $49,000 to a uni-401(k) plan (annual addition limit of $44,000 plus catch-up of $5,000). A defined benefit plan with retirement age 60 would allow for contributions of $160,000 or more plus $20,000 for 401(k) with catch-up.

❑ ***Comparability profit-sharing plans.*** Consider a comparability plan for clients who would like to keep the contribution discretionary and to have different contribution percentages for different categories of participants.

❑ ***Safe-harbor plans.*** These plans eliminated many of the issues with testing associated with 401(k) plans. Consider them if you have bumped into limits to the levels of contributions of highly compensated participants. Certain structures permit a double use of a safe-harbor contribution, enabling reduced levels of profit-sharing dollars to achieve maximum contribution levels. Safe-harbor elections for 2007 must be made prior to December 1, 2006.

Source: Stuart L. Youngentob, CPA, JD, Arkin Youngentob Associates LLC, Bethesda, Md., and Carolyn Lloyd-Cohen, CLU, ChFC, Preferred Pensions LLC., Clifton, N.J., National Financial Partners Affiliated Firms.

Social Security: What's the Magic Age?

When to start collecting your benefits.

by Kathryn Garnett

PHOTOGRAPH BY WILLIAM WHITEHURST/CORBIS

What's the best age to begin collecting Social Security benefits? Is it 62? 65? 67? Here's a guide to help you maximize your financial security—and that of your clients—through your 60s and beyond.

How the System Works

In order for workers to receive Social Security benefits, they must meet certain criteria. The basic requirement for eligibility is the accumulation of 40 work credits during one's working life. A worker earns one work credit for predetermined dollar earnings ($970 in 2006), to a maximum of four work credits in any calendar year. Full-time workers earn this easily in the early part of the year; even part-time workers can earn the requisite work credits within 10 years.

The second computation is the average of the worker's highest 35 years of earnings. These years need not be consecutive, but any "0" years lower the average. The good news is that earnings are adjusted for inflation. An inflation factor is applied to all earnings before age 60, making them approximate current dollars. The amount of the benefit a worker receives is a percentage of that calculated amount.

Early Birds

About 50% of men and 60% of women take Social Security benefits at age 62.

Because the intent of Social Security is to provide a safety net for low-income workers, the system is designed to provide higher benefits to this group. Where a high-income worker might receive re-

placement of about 25% of income, workers who earned minimum wages throughout their working lives might receive as much as 62% pay replacement.

The third variable in determining your benefits is the age at which you begin to draw them (see exhibit 1, below). In the early 1980s, in order to meet a potential shortfall in funding, Social Security revised the "Full Retirement Age" schedule, spreading out the age at which workers could receive full benefits from the system. The ability to draw early benefits at age 62 did not change, but be aware that discounts apply for early payment of benefits. The discount for early payment of benefits is calculated in two stages. For the first 36 months of early filing, payment is reduced 5/9 of 1% per month; then payment is reduced 5/12 of 1% for each additional month. As an example, if you opt to begin your benefits at 62 and your full retirement age is 66, you will be drawing your benefit four years—or 48 months—early. Your payment would then be about 75% of your full benefit. When you opt for this early benefit, you will continue at this lowered amount throughout your life.

Advising Clients

When a client asks a CPA for advice on when to begin taking benefits, many factors need to be considered. We'll review some of the reasons to take benefits early, at full retirement age or at a later date.

Early benefits. Why begin your benefits at the earliest possible age? Let's consider two examples. Monica has worked hard all her life, but never was able to earn more than low-level wages. Now she is nearing 62 and finding that her health is going to force her into retirement earlier than she had planned. She has not worked for large employers who provide pension benefits nor has she had access to a 401(k) savings plan. She does not own a home. Monica will be dependent upon her Social Security benefits for subsistence after she leaves the workforce. With no other income available and little prospect of future employment, she'll need to apply for her Social Security benefit at the earliest possible time.

Sam has had a reasonable work income for many years and at 64 is planning to slow down. While he will continue working for several more years, he wants to cut back on physical work. Sam will need more income than part-time work can generate. He can continue to maintain his current lifestyle by adding Social Security to his resources.

Early benefits—pros and cons. Early benefits can provide the much-needed safety net for anyone who has no other source of income, or whose income is not sufficient to cover day-to-day living needs. However, this lowered benefit will not increase at full retirement age, so, with the exception of cost-of-living increases, the retiree can expect to have the lowered income for the rest of his or her life. Still, the spouse will receive a certain percentage of the worker's *full retirement amount* (the benefit payable to the worker at full retirement age).

Another consideration is the penalty that is attached to some earnings when you receive Social Security benefits. Each year Congress establishes a maximum amount that working beneficiaries already collecting retirement benefits can earn without penalty. Prior to full retirement age, any amount earned over that maximum is penalized; 50% of the "excess" earnings are deducted from the Social Security benefits. This earnings maximum and penalty apply only prior to reaching full retirement age. After reaching full retirement age, the beneficiary can earn any amount without penalty.

Full retirement age. There are good reasons for beginning to take benefits at full retirement age, which now is set between 65 and 67.

For example, let's take the case of Catherine, who for most of her life has

Where It All Began

In the 1930s, while the country still was reeling from the Great Depression, it became evident that senior citizens were among those most adversely affected. As part of his New Deal, President Franklin D. Roosevelt introduced the Social Security System, with the goal of keeping elders above the poverty line. There was not then, nor has there ever been, any premise that Social Security would be a retiree's sole income. The program was designed to provide a safety net to ensure that senior citizens could maintain at least a minimum standard of living. The bulk of retirement living expenses always has been from other sources such as pensions and personal savings.

Exhibit 1 Full Retirement Age

Year of birth	Normal retirement age	Payment at 62
1937 or earlier	65	80% of full benefit
1938	65 & 2 months	79.2%
1939	65 & 4 months	78.3%
1940	65 & 6 months	77.5%
1941	65 & 8 months	76.7%
1942	65 & 10 months	75.8%
1943–1954	66	75%
1955	66 & 2 months	74.2%
1956	66 & 4 months	73.3%
1957	66 & 6 months	72.5%
1958	66 & 8 months	71.7%
1959	66 & 10 months	70.8%
1960 and later	67	70%

Planning for Social Security

BY TED SARENSKI

"Social Security will not be around by the time I retire" is a statement often made by members of the baby-boom generation and those younger. Why even read an article regarding collection of Social Security benefits if they won't be received? A look at the 2005 annual report from the Social Security and Medicare Boards of Trustees reveals that it will be around for generations of Americans who will reach retirement age in the future.

The report estimates that Social Security could be brought into actuarial balance over the next 75 years by increasing the amount of payroll taxes being currently charged by 15%, reducing current benefits by 13% or some combination of the two. The longer changes to the benefit system are delayed, the costlier the fix becomes. The report states that if no changes are made, the average benefit would need to be slashed to 74% of the projected benefit in 2041, the estimated year that trust fund outflows would need to equal inflows for the program to remain solvent.

Medicare's projected shortfall is predicted to come much sooner than the Social Security shortfalls, as health care costs are rising faster than workers' wages. The Board of Trustees estimates the Medicare funds shortfall will occur by 2020 at the current rate of collection and payment. It suggests an immediate increase of 107% in income to the program or an immediate reduction by 48% in benefits being paid, or a combination of the two, to keep the program solvent for the next 75 years. As with Social Security, the cost of solutions increases with delayed response.

The Board of Trustees report explains the statistical and actuarial processes used in arriving at their conclusions but never, in any section, suggests the Social Security or Medicare programs will disappear. It is important, however, for our society to address the issues earlier rather than later.

As the defined benefit pension plans of a generation ago have dwindled, individuals need greater personal savings in the form of larger 401(k) plan contributions, IRA contributions and after-tax savings to fund their desired standard of living in retirement. Company-sponsored pension plans have not disappeared, but neither they nor Social Security can be relied on to fully support someone's standard of living in retirement. Still, Social Security is a very important piece of our society's safety net that needs to be preserved for future generations.

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been a full-time worker and a dedicated saver in her 401(k) plan. Although she has reached her full retirement age, she does not plan to retire for several years. Even though she does not need the income she will receive from Social Security at this time, she will put it in a savings account to provide income when she does retire in a few years. Since there is no penalty on earnings after reaching full retirement age, Catherine will benefit from accumulating a nest egg for her early years of retirement and postpone drawing from her tax-deferred savings until she reaches the age of 70½.

Full retirement age—pros and cons. The full benefit one has earned is available without any penalty at normal retirement age, and the beneficiary can continue to work with no lowering of Social Security benefits. However, if the beneficiary earns substantial income, a large portion of the Social Security payment may be subject to federal income tax. (See "Taxation of Social Security," page 32.)

Late benefits. Now, let's look at examples of why people might wait beyond their full retirement age to begin drawing their Social Security benefit. Eldon has been a successful businessman for the past 40 years, holding executive positions that have paid him more than the annual earnings limits. He can expect to draw the maximum benefit of

EXECUTIVE SUMMARY

- **In determining the age at which a worker should apply** for Social Security benefits, consideration should be given to current and expected future sources of income, age of beneficiary and spouse, health issues that could affect longevity and whether the beneficiary will continue to work while receiving benefits.
- **There is no "one-size-fits-all" answer** for deciding when Social Security benefits should be started. Many workers will benefit by beginning to receive benefits at age 62 due to their circumstances and needs. For others, waiting until full retirement age, or even later, will provide higher annual income in the years ahead when their expenses might outpace their resources.
- **How long does it take to break even** in the game of taking benefits at early vs. normal retirement age? If two retirees are now 65 and one started collecting Social Security benefits at age 62 and the other starts now, they will collect the same total amount of money when they are 77 years old.
- **It's important to do preretirement calculations** at least every three years, to take into account any changing circumstances and/or changes in the rules as they apply to Social Security benefits, pensions and investment savings.

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Exhibit 2 Best Ages for Married People to Claim Social Security

Here's the optimal plan for a married couple in good health:

Age difference	Wife's earnings as percentage of husband's		
	0%–30%	30%–40%	40%–100%
0 years	66 husband, 66 wife	67 husband, 66 wife	69 husband, 62 wife
3	68, 65	69, 62	69, 62
6	68, 62	69, 62	69, 62

Source: Alicia H. Munnell and Mauricio Soto, Center for Retirement Research.

$2,053 a month when he reaches full retirement age. He also has deferred the maximum into his 401(k) plan, which now has a substantial balance that will easily fund his retirement years. Since he does not need the additional funds during his early retirement years, Eldon will wait until he is 70 to begin receiving his Social Security benefit, which by then will be nearly $2,700, thereby assuring a larger safety net should his investments drop in value, and also assuring his spouse a higher income should he predecease her.

Irma has worked as a professional most of her adult life. As she looks at her future finances, she considers her longevity in light of the fact that her parents and grandparents all lived to be close to 100 years of age. Knowing that she may live longer than the average person, and that her medical expenses may soar in her later years, Irma chooses to delay her Social Security benefits. For now she has sufficient resources to maintain her standard of living, but she realizes that her needs may exceed her resources down the road. By waiting until age 70, Irma knows her current benefit of $1,685 a month will grow to $2,207.

Late benefits—pros and cons. The lure of higher payments makes late benefits appealing to many people. But none of us knows how long we will live. Postponing benefits could mean less benefits, or none at all, should we die before beginning withdrawals. The increase in benefits (which is about 8% per year) lasts only until age 70; after that benefits remain at the 70-year-old level.

If a worker lives to full life expectancy, he or she will receive the same dollar total from the Social Security Administration (SSA) whether benefits started early, at full retirement age or late. Early recipients get more but smaller checks; later recipients get fewer but larger checks. Actuarially, it's a wash, so other considerations must be the deciding factors.

> Early Social Security recipients get more but smaller checks; later recipients get fewer but larger checks.

Breaking Even

How long does it take to break even in the game of taking benefits at early vs. normal retirement age? Let's take Joan and Mary as examples. Both are now 65 years old. Joan started collecting benefits at age 62; Mary is just beginning to collect now, at age 65. Because Joan has had a three-year head start on collecting benefits, it will take Mary 12 years to catch up. It will not be until they are both 77 years old that they will have collected the same total amount of money. After that, since Mary will continue to receive a bigger check every month, the total amount of Social Security she collects will be larger than Joan's total. So the break-even age is 77. The average retiree who begins taking benefits early will come out ahead only if he or she dies before that age, and the average retiree who waits until full retirement age will collect more money only if he or she lives longer than that.

The SSA provides each worker with a benefit estimate every year. This is important information for CPAs working with clients in planning for their financial health in retirement. As circumstances change and rules regarding Social Security, pensions and various investment vehicles are updated, it is important to review and adjust retirement calculations at least

AICPA RESOURCES

Conference

- AICPA Advanced Estate Planning Conference
San Diego
July 26–28

CPE

- Retirement Planning That Works for Your Client (# 730840JA).

For more information, to place an order or to register, go to **www.cpa2biz.com** or call the Institute at 888-777-7077.

OTHER RESOURCES

AARP Publications

- 800-424-3410; **www.aarp.org/money/social_security**.
Offers articles of current interest on all areas of Social Security, including a retirement calculator.

Social Security Administration

- 800-772-1213; **www.ssa.gov**
Sign up for the SS eNewsletter, apply for benefits, ask a question and read the annual Trustees' Report.

every three years. You may request this information through the SSA Web site (**www.ssa.gov**), by calling 1-800-SSA-1213 and requesting the Personal Statement Request Form (SSA-7004), or by using "AnyPIA" Computation Software (available at **www.ssa.gov/OACT/ANYPIA/compute.html**) on your PC.

Taxation of Social Security

Your clients should be prepared to pay income tax on some Social Security benefits. There are two steps to determine how much of the benefit is subject to taxation:

- Find the sum of the following three amounts: adjusted gross income, nontaxable interest income (for example, from municipal bonds) and "countable" Social Security (half of the yearly Social Security amount).
- Compare this result to the IRS base amount (for 2006 this is $32,000 for a married couple and $25,000 for an individual).

If the result of Step 1 exceeds the IRS base amount, 0% to 85% of the Social Security benefit is taxable. The IRS tax return instructions provide the formula for determining the individual's tax liability.

An example for a married couple:

Adjusted gross income:	$30,000
Nontaxable interest income:	$3,000
50% of annual Social Security of $16,000:	$8,000
	$41,000

Since $41,000 exceeds the IRS base amount of $32,000 for a married couple, they would use the IRS instructions to determine their individual tax liability. See exhibit 2, page 31, for the best age for married couples to begin collecting Social Security benefits.

People Need Guidance

Trying to find their way through the Social Security System often leaves American taxpayers feeling at a loss, and many need professional help when making decisions that will have a long-term effect on their financial picture. Using the examples above, CPAs can help clients weigh their options, consider their individual situations and determine the best course for receiving this valuable entitlement. ❖

Practical Tips

- ▶ Consider clients' health and other sources of income, among other things, when advising them on whether to take benefits early, at full retirement age or late.
- ▶ Make your clients aware of the tax implications of earning wages while receiving Social Security benefits.

Going Forward With Reverse Mortgages

The benefits and pitfalls of borrowing against your home.

by Howard Godfrey and Edward Malmgren

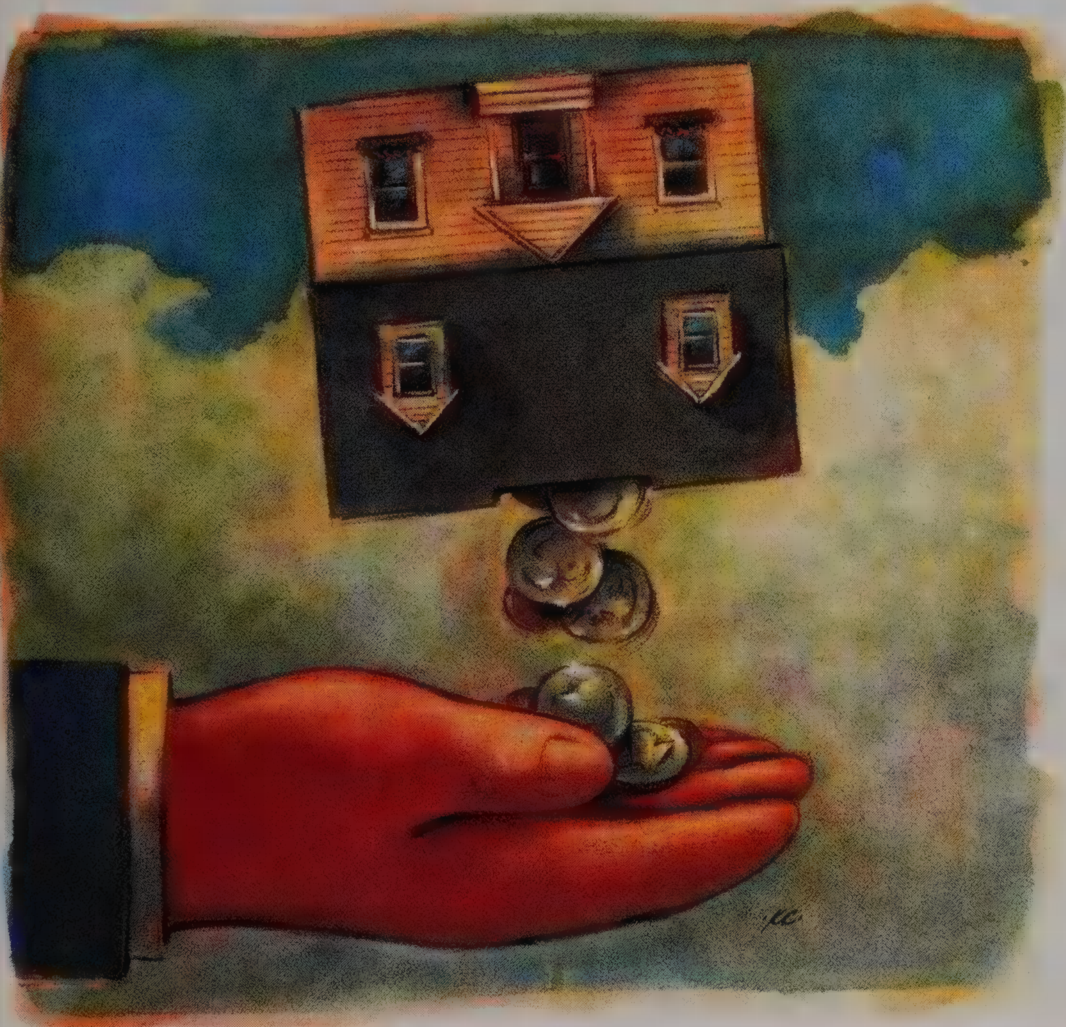

ILLUSTRATION BY KEN CONDON/IMAGES.COM/CORBIS

Reverse mortgages were created in 1987 by the Department of Housing and Urban Development (HUD) to provide greater financial security to American homeowners age 62 and older. With the aging population in the United States and the rapid appreciation of residential property, the reverse mortgage industry is destined to continue to grow. Reverse mortgages often are thought of as the solution for elderly citizens who need additional funds; however, they can be a costly solution and should be used with caution.

This article will help CPAs recognize situations where reverse mortgages can provide much-needed supplementary retirement income—and equally important, when they should be avoided.

> A total of 157 home equity conversion mortgage loans were made in fiscal year 1990. By 2005, the number had skyrocketed to 43,131.
>
> Source: Department of Housing and Urban Development, www.hud.gov.

WHAT ARE REVERSE MORTGAGES?

A reverse mortgage is a loan against home equity that requires no repayment as long as the owner continues to live in the home. An HECM (see box below) must be a first mortgage, which means any existing mort-

> About 90% of all reverse mortgages are Home Equity Conversion Mortgage (HECM) loans, which are discussed in this article. HECM loans were designed by HUD and are insured by the Federal Housing Administration (FHA). Other home-equity loans not covered in this article may have unique advantages, such as the absence of the lending limits that are applicable to federally insured loans, and drawbacks, such as higher costs.

gage debt must be paid off first, possibly with some of the reverse mortgage funds. This reverse mortgage provides a line of credit, one or more lump-sum advances and/or a series of periodic advances that may continue until the last surviving borrower leaves the home permanently. Reverse mortgage debt increases over time as a result of advances to the homeowner that increase the principal, and the accumulation of service fees and accrued interest.

The reverse mortgage debt does not become due until the house is sold or the homeowner(s) move out permanently. At that time the lender likely will receive payment of the loan balance through the sale of the home, though in order to keep the house in the family, the homeowner or family members may choose to pay off the mortgage with other funds. If the sales proceeds are insufficient to pay off the mortgage, the shortfall is covered by mortgage insurance, which is required with an HECM. Sale proceeds in excess of the debt go to the homeowner(s) or the estate.

REVERSE MORTGAGE LIMITS

Since the homeowner is not expected to make payments on a reverse mortgage, no minimum income level is needed to qualify for the loan. The borrower's health and credit rating also are irrelevant. The amount of debt that may be incurred is based on the value of the home, the age of the homeowner and expected interest rates. An older taxpayer can qualify for larger monthly advances and/or a larger lump-sum advance because of the shorter life expectancy over which the loan balance will grow (see exhibit 2, at right). Lower interest rates also allow greater borrowing because there will be less accrued interest. The impact of age on borrowing capacity is seen in exhibit 2 with a $250,000 home, where mortgage rates are 6%.

Exhibit 2

Know Your Limit

Sample age and credit-line limits for a $250,000 house at 6% interest.

Age	[illegible]
65	$129,425
75	$154,538
85	$181,460
90	$194,150

Source: AARP, *HomeMade Money*, page 11.

The home value that may be used in calculating an HECM is capped by the FHA. The limit varies from $200,160 in areas with lower median home values to a maximum of $362,790 in many major metropolitan areas where home values are higher. So a $1 million home and a $400,000 home might be eligible for exactly the same loan amount. Of course the maximum loan would be lower for a home worth less than $200,160. The lower limit of $200,160 is applicable in about 80% of the counties in the United States.

HUD cautions homeowners that they should not need to hire a paid consultant to find a reverse mortgage lender, because HUD provides a list of HUD-approved lenders. But all loan applicants must obtain HUD-approved, third-party counseling before proceeding, because reverse mortgages are complex and potentially costly. HUD re-

Exhibit 1

Reverse Mortgage Meets Needs of Elderly

Joe Homeowner is 85 years old and his wife Jan is 84. Their home, valued at $300,000, is debt-free. They are committed to living in their home as long as possible. Their Social Security benefits and interest on savings have been adequate for their living costs, but they now need in-home nursing care several days a week at a cost of about $1,000 per month.

Joe and Jan do not want to be a financial burden to their children. They do not qualify for a bank loan to cover these extra costs because they do not have extra income to cover loan payments. They could sell the home, but they would need to find alternative housing. A reverse mortgage may be a good way to get the funds they need to balance their budget.

EXECUTIVE SUMMARY

- **Increased life expectancy has caused the elderly** to need more funds after retiring, especially if they elect early retirement. The home is often the most valuable asset an individual owns.
- **Reverse mortgages allow homeowners to continue to live** in their homes while borrowing against the equity. A reverse mortgage may provide a lump-sum advance, a line of credit and/or periodic advances. Monthly advances may be received as long as the homeowner lives in the home. Best of all, the homeowner never needs to make a mortgage payment.
- **A lump-sum advance from a reverse mortgage may be used** to pay off the existing first mortgage and eliminate the monthly mortgage payment, reducing monthly cash requirements.
- **Caution is required because reverse mortgages can be** prohibitively expensive unless the homeowner has a substantial amount of home equity, plans to convert all or most of the equity into retirement funding and lives in the home and benefits from the reverse mortgage for the long term.
- **A homeowner who allows reverse mortgage payments to** increase checking or savings balances beyond certain limits may lose government benefits.

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quires the counseling to include topics such as alternative sources of financial assistance, other home-equity conversion options, the financial implications of the HECM such as rising debt-falling equity, the possible effect of the loan on public programs such as Medicaid and details of loan options and payment plans. This counseling is provided free or at a nominal cost. The HECM, which provides funds for medical costs and other living expenses during retirement, is not intended to be used by seniors as a source of funds for making investments, loans to relatives and so on. Exhibit 3, at right, describes some situations in which a reverse mortgage may be a good option and some in which it is not.

Exhibit 3 Likely Candidates

Those who can get the most from a reverse mortgage:

- Homeowners who are much older than the minimum age of 62. For an older homeowner, the life expectancy suggests there will be fewer remaining years for reverse mortgage advances and less accumulated interest and service fees. The homeowner can receive larger advances over a relatively short period without projecting a loan balance that will exceed the value of the home.
- Homeowners with small balances on their mortgages and those who are debt-free can receive larger reverse mortgage advances.
- Homeowners who are having difficulty paying an existing mortgage can use a reverse mortgage to eliminate the monthly mortgage payment.

Those who can get little benefit from a reverse mortgage:

- Homeowners who are just above the minimum age of 62. Because their life expectancy suggests there will be many remaining years for reverse mortgage advances, there will be more accumulated interest and service fees.
- Homeowners with little equity in their homes are limited to smaller advances.
- Homeowners who plan to move to another living situation such as a nursing home within a few years. They may incur high costs and receive relatively small benefits, especially if they select a monthly advance option.

Comparison Shopping

The monthly adjusted HECM provides the largest loan at the lowest interest rate. However, the annually adjusted HECM, with a higher initial interest rate, has less risk, because the increase on interest rates is capped at 5 percentage points, compared with 10 for the monthly adjusted HECM. If a borrower allocates some (or all) of the net principal amount to an HECM line of credit, the unused portion of that credit will increase over time, at a rate tied to the accruing interest rate.

Both the monthly and the annually adjusted HECM have an initial mortgage insurance premium of 2% of the maximum

The Impact of the Deficit Reduction Act of 2005

BY MICHAEL DAVID SCHULMAN

One major unknown factor concerning reverse mortgages is the impact that the Deficit Reduction Act of 2005 will have on them. Because one of the goals of the act is to reduce government spending on Medicaid, it legislates that Medicaid be denied to applicants with more than $500,000 in home equity. As a result, more and more older adults will be required to pay for their own health care. It is expected that the number of reverse mortgages will increase as a result.

The Deficit Reduction Act also requires the state be named as a remainder beneficiary in annuity contracts, presumably to permit states to recover their Medicaid costs. While the details, on a state-by-state basis, have yet to be worked out, it seems clear that many planning situations that would have been solved through the use of an annuity contract (whether issued by an insurance company or a so-called "private annuity") will need to find an alternative income source. Despite looking like annuities, reverse mortgages are a form of borrowing, so the "remainder to the state" rule referred to above does not apply. Reverse mortgages likely will be used in many of these cases.

Another "not yet determined" aspect of the Deficit Reduction Act and reverse mortgages is who gets the money when the house is sold. Put differently, the lender is in a primary position on a reverse mortgage. However, Medicaid also can put a lien on an older adult's residence as benefits are paid. What will happen if Medicaid insists on being first? Or, if a Medicaid lien is in effect when an adult wishes to take a reverse mortgage, will Medicaid take a subordinate position to the mortgage lender?

As with any financial product being marketed to older adults, CPAs must take care to protect the client from financial fraud. In general, it is inappropriate to purchase a reverse mortgage—or any investment product—from a "door-to-door" vendor. Many of these products have extremely high fees, closing costs and interest rates that can trap the unwary homeowner.

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Exhibit 4 FHA/HUD Monthly Adjustment Reverse Mortgage

Part 1 – Initial Loan Computations

Applicants' ages: 84 & 85. Home value: $300,000 (No existing debt). Available principal limit: $156,525.12.
Costs financed: Initial mortgage insurance premium of $4,003.20,
origination fee of $4,003.20, closing costs of $1,561.32.

Line		Information	
1	Initial interest rate	5.87%	
2	Actual interest rate (Includes mortgage insurance premium of .5%)	6.37%	
3	Expected interest rate over life of loan (Projected rate)	5.85%	
4	Cap on interest rate throughout term of the loan (Note 1)	15.87%	
5	Monthly fee to institution that services the loan	$35	
6	Estimated home value	$300,000	
7	Lending limit (Lesser of home value or FHA limit for area)	$200,160	
8	Credit line growth rate	6.37%	
9	Loan principal limit	$156,525.12	
10	Set aside for service fees over life of loan	(4,207.65)	
11	Available principal limit	$152,317.47	
12	Initial mortgage insurance premium (MIP) 2% of home value	(4,003.20)	Financed
13	Origination fee (Assume the fee is added to loan amount)	(4,003.20)	Financed
14	Closing costs (Attorney fees, etc.) added to loan	(1,561.32)	Financed
15	Net principal limit (Note 2)	$142,749.75	
16	Less: Advance to pay off existing mortgage, etc., if any	$0.00	
17	Less: Set-aside for automatic payment of taxes & insurance	$0.00	
18	Cash available for advance, credit line and/or annuity	$142,749.75	
19	Monthly payment for life (Tenure option) (Note 3)	$1,187.42	
20	Financed fees & closing costs (Lines 12, 13 and 14)	$9,567.72	

Part 2 – Computations Over Life of Loan

									Cumulative advances & costs			
Year	Age	Rate (Excludes MIP)	Beginning Loan Balance	Cash to Owner (Advances)	Service Fees	Mortgage Insurance Premium	Accrued Interest	Ending Balance (Sum: E-H)	Total Advances (Column E)	Accum. Costs (I less J)	Average Per Year (K / A)	Percent of Average Balance
A	B	C	D	E	F	G	H	I	J	K	L	M
0	84		Beginning balance – Financed costs					$ 9,568				
1	85	5.87%	$ 9,568	$14,249	$420	$ 90	$ 1,054	$ 25,381	$ 14,249	$ 11,132	$11,132	63.7%
2	86	5.87%	25,381	14,249	420	171	2,010	42,231	28,498	13,733	6,866	26.5%
3	87	5.87%	42,231	14,249	420	258	3,028	60,186	42,747	17,439	5,813	16.7%
4	88	5.87%	60,186	14,249	420	350	4,114	79,319	56,996	22,323	5,581	12.6%
5	89	5.87%	79,319	14,249	420	449	5,270	99,707	71,245	28,462	5,692	10.4%
6	90	5.87%	99,707	14,249	420	554	6,502	121,432	85,494	35,938	5,990	9.1%
7	91	5.87%	121,432	14,249	420	666	7,815	144,582	99,743	44,839	6,406	8.3%
8	92	5.87%	144,582	14,249	420	785	9,215	169,251	113,992	55,259	6,907	7.7%
9	93	5.87%	169,251	14,249	420	912	10,706	195,538	128,241	67,297	7,477	7.3%
10	94	5.87%	195,538	14,249	420	1,047	12,295	223,549	142,490	81,059	8,106	7.0%
11–12	96	5.87%	223,549	28,498	840	2,537	29,780	285,204	170,988	114,216		
13–14	98	5.87%	285,204	28,498	840	3,192	37,478	355,212	199,486	155,726		
15–16	100	5.87%	355,212	28,498	840	3,937	46,219	434,706	227,984	206,722		

Notes

1 FHA-HUD loan – The interest rate cap is the initial rate plus 10% (15.87% maximum rate).

2 This is the estimate of the maximum amount of the loan. The loan balance will be equal to financed initial loan costs, plus amounts shown in columns E, F, G, H above. Balance would increase by automatic payments for taxes & insurance if that option were chosen (Part 1, Line 17).

3 Homeowners may borrow up to $142,749.75 immediately. Alternatively, these homeowners may receive advances of $1,187.42 per month for life. They may choose a combination of advances.

4 The accumulated loan balance may exceed initial home value, but the home value is expected to increase with inflation (to $561,894 in this case). If this loan is outstanding for 16 years, the loan balance is projected to reach $434,706.

claim amount (the lesser of the value of the home or the FHA loan limit) as well as an annual mortgage insurance premium of one-half of one percent of the loan balance. The origination fee is limited to the greater of $2,000 or 2% of the maximum claim amount. The origination fee, upfront mortgage insurance premium and other closing costs may be financed as part of the reverse mortgage.

Example. Joe and Jan Homeowner have a $300,000 home, but the FHA lending limit for their area is $200,160, which is their maximum claim amount. They choose the monthly adjustable HECM. (Exhibit 4, page 38, shows how to compute the amount of reverse mortgage funds available, loan costs and so on.) The initial interest rate is 5.87% and the expected future rate is 5.85%, with a cap of 15.87%. There is also a charge of 0.5% of the mortgage balance each month for mortgage insurance.

The loan principal limit is $156,525.12, which is computed with a formula that takes into account the maximum claim amount of $200,160, a HUD limit factor and expected future interest rates. A set-aside is deducted for future monthly loan processing fees, leaving an available principal limit of $152,317.47. Joe and Jan choose to finance the initial mortgage insurance premium of 2% of the maximum claim amount ($4,003.20) and the origi-

» Practical Tips

- Suggest a reverse mortgage only if your client has substantial equity in the home, plans to borrow a large part of that equity and plans to live in the home for the long term.
- Don't recommend a reverse mortgage for small loans such as minor home repairs.
- Advise against getting reverse mortgages for investments or loans to friends or relatives.
- HUD provides information and face-to-face or phone counseling about HECM loans free or at nominal cost.

nation fee, which also is $4,003.20, as well as other closing costs of $1,561.32. This means that they have a loan balance of $9,567.72 before they begin receiving reverse mortgage advances. These financed costs reduce the net principal limit to $142,749.75.

Their first option is to receive monthly advances of $1,187.42 for as long as either one of them lives in the home. They also have the option of receiving more, say $1,500 per month, for only a fixed period.

TAX IMPLICATIONS

A reverse mortgage may be tax-neutral. Money received from a reverse mortgage payout is not taxable income. The borrower continues to be liable for property taxes, for which he or she still qualifies for a tax deduction. A borrower with no existing mortgage will have no interest deduction to lose, but a borrower who refinances a standard mortgage with a reverse mortgage will lose the annual mortgage interest deduction. Since no interest payments are made, cash-basis taxpayers cannot take a current deduction for mortgage interest and other costs that the lender pays or accrues; that deduction potentially will be available only when the mortgage is paid off.

LOAN ACCELERATION CLAUSES

A homeowner with an HECM is responsible for taking care of the property that likely will be sold in the future to pay the loan balance. Such responsibilities include home repairs, property taxes, and fire and storm insurance. Failure to fulfill such responsibilities may cause the reverse mortgage loan to become due. The homeowner also can cause acceleration of the loan by renting out the home to another party, adding a new owner to the home's title, changing the home's zoning classification or taking out new debt against the home.

THE BOTTOM LINE

A reverse mortgage makes economic sense for you or your clients only when it will be long-term and there is substantial equity in the home. When considering a reverse mortgage, homeowners should evaluate their commitment to remain in the home and their current state of health. They also should consider whether in-home health care will be available if needed from family members, friends or health care professionals. Then, they should obtain a reverse mortgage only if it does not have the downside features listed in exhibit 5, at left. The CPA's advice here may be critical. After all, what's involved is the client's most valuable asset, the home. ❖

Exhibit 5 The Upside and the Downside of a Reverse Mortgage

UPSIDE

Keep the home and receive cash. Borrowers can stay in their homes and convert their equity to cash without having to make current loan payments.

Larger amounts when older. Older borrowers are able to obtain a larger monthly advance because they have a shorter life expectancy.

DOWNSIDE

Expensive for short-term borrowers. Substantial loan origination fees and mortgage insurance premiums are required, as well as annual interest and service fees. At the end of the first year, the loan balance will include reverse mortgage advances received during the year, accrued service fees, all of the costs of getting the loan that were financed and accrued interest. Part II of Exhibit 4, page 38, shows that if the loan with a 5.87% initial interest rate is outstanding for only one year, the accumulated loan costs are 63.7% of the average loan balance; the average loan cost will be 26.5% if the loan is outstanding for two years. If the borrower dies or moves into a nursing home within a few years, the loan will have been a very expensive source of funds.

Expensive for small amounts. HECM loan costs are based on the home value or loan limit, not on the amount the homeowner wants to borrow. If the borrower needs only a relatively small amount (for example, $10,000 for a new roof), closing costs are very large relative to the amount of benefit received.

Risk of losing government benefits. Reverse mortgage advances will not be considered income and will not affect Medicaid coverage, but any resulting unspent cash balance may be a problem if it exceeds Medicaid asset limits. To avoid this, the homeowner should borrow only enough to meet current needs.

AICPA RESOURCE

CPE

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OTHER RESOURCES

- *HomeMade Money: A Consumer's Guide to Reverse Mortgages*, AARP, 2006, **www.aarp.org/money/revmort/revmort_basics/a2003-04-07-homemademoney.html.**
- *Money from Home—A Guide to Understanding Reverse Mortgages*, Fannie Mae, **www.fanniemae.com/global/pdf/homebuyers/moneyfromhome.pdf;jsessionid=TLJOMSJSJIUTHJ2FQSHSFGA.**
- National Reverse Mortgage Lenders Association (NRMLA), headquartered in Washington, D.C., is the national voice for lenders and investors engaged in the reverse mortgage business, **www.reversemortgage.org.**

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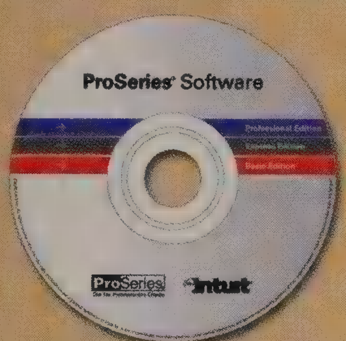

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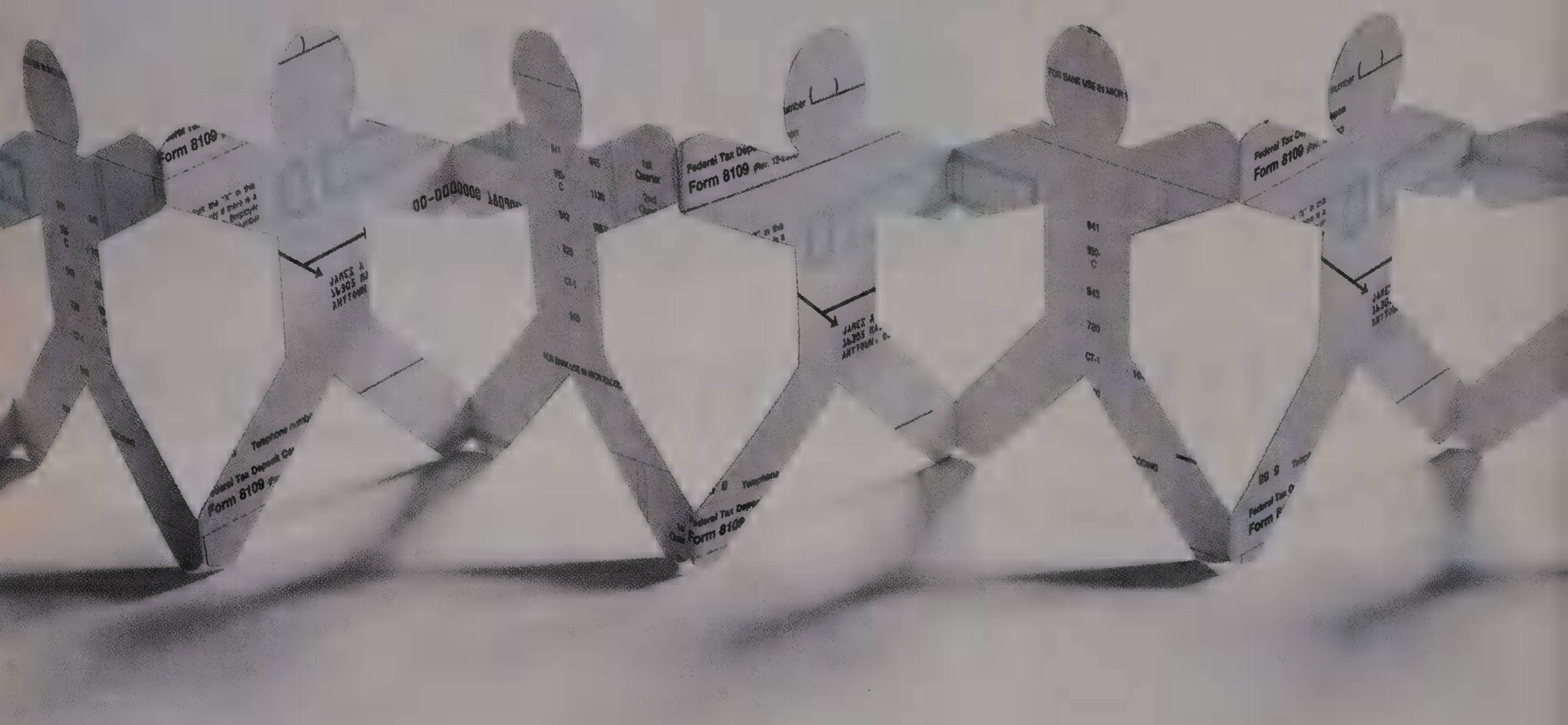
Form 8109

Assessing and Responding to Risks in a Financial Statement Audit

Auditors must leave a clear record in private company audits.

by John A. Fogarty, Lynford Graham and Darrel R. Schubert

This is the first of two articles describing the requirements of—and implementation suggestions for—new guidance from the Auditing Standards Board (ASB). This article discusses the process of assessing risks and controls, leading to the concept of the risk of material misstatement. A subsequent *JofA* article will discuss how the auditor responds to the risk of material misstatement.

These eight standards (see exhibit 1 at right, and "The New World of Auditing Standards," *JofA*, May05, page 59) are designed to help auditors plan and perform audit procedures that will address assessed risks, enhance the auditor's response to audit risk and materiality, facilitate planning and supervision and clarify the concept of audit evidence.

Expected Benefits of the Standards

The standards are designed to result in more effective audits as a result of better risk assessments and improved design and performance of audit procedures to respond to the risks. Auditors will be able to focus on those areas where the risk of misstatement is the greatest.

Exhibit 1

The Audit Risk Standards

- SAS no. 104, *Amendment to Statement on Auditing Standards No. 1*, Codification of Auditing Standards and Procedures ("*Due Professional Care in the Performance of Work*")
- SAS no. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards
- SAS no. 106, *Audit Evidence*
- SAS no. 107, *Audit Risk and Materiality in Conducting an Audit*
- SAS no. 108, *Planning and Supervision*
- SAS no. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- SAS no. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- SAS no. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling

The new standards also clarify the phrase "sufficient knowledge of internal control to plan the audit" as used in the professional literature. A resulting benefit is that the auditor will have a better basis for determining the nature, timing and extent of further procedures and assessing potential fraud risks.

In addition, the standards emphasize the use of assertions to link the risks, controls, audit procedures and conclusions. Auditors can use this technique to determine whether audit procedures are responsive to identified risks

SAS no. 107 makes it clear that the overall objective of an audit is to provide reasonable assurance that the financial

statements are free of material misstatement. The term *reasonable assurance* has been subject to varying interpretations, but has now been clarified by the ASB as meaning a high, although not absolute, level of audit assurance.

To ensure that management, those charged with governance and the auditor agree on what the audit will involve, SAS no. 108, *Planning and Supervision*, says that the auditor should have a written understanding with the client regarding the terms of the engagement (see "The Heart of the Matter," at right).

The Heart of the Matter

- SAS no. 107, *Audit Risk and Materiality in Conducting an Audit*, makes clear that the overall objective of an audit is to provide reasonable assurance—a high, but not absolute level of assurance—that the financial statements are free of material misstatement.
- SAS no. 108, *Planning and Supervision*, says that the auditor should have a written understanding with the client regarding the terms of the engagement.

Materiality

In the performance of a GAAS audit, the auditor *must* assess materiality and audit risk. Although the concept of materiality relates to auditing, it is rooted in accounting and user needs. SAS no. 107, *Audit Risk and Materiality in Conducting an Audit*, identifies the user as having, among other attributes, a knowledge of business activities and of the limitations that materiality and estimation place on an audit and a willingness to study the financial statements. SAS no. 107 clarifies that when auditors assess materiality, they should consider the needs of users as a group, not just those of specific individuals.

While the standards do not suggest specific materiality benchmark percentages, they do suggest the common benchmarks of income, revenues and assets. For example, profit-oriented entities may use an income-based materiality. Forthcoming AICPA audit guides on risk assessment and audit sampling will provide more detailed information regarding the establishment of appropriate benchmarks.

Due to the possible aggregating effects of immaterial misstatements and the need to opine at a low risk, auditors should design procedures at the account- or stream-of-transactions level, using a test threshold that is lower than the overall materiality level.

Risk Assessment

This phase of the audit process is not just a planning tool, but an integral part of evidence gathering. Since risk assessment directs the auditor's attention to issues that merit further consideration, it should be based on the inquiries, observations and audit evidence gathered by the auditor; this gathering and documentation of evidence is important. Generally, simple inquiries of management are an insufficient basis for this assessment. In addition, according to SAS no. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, risk assessment procedures alone are not a sufficient basis for rendering the audit opinion.

As part of the risk assessment process, the engagement team should hold a brainstorming session to consider the nature and magnitude of possible misstatement risks. This session may be combined with the brainstorming session on fraud risks required by SAS no. 99, *Consideration of Fraud in a Financial Statement Audit*. To meet this requirement, a sole practitioner might challenge himself or herself to be objective and critical when updating past risk assessments and documenting changes in the business environment.

While not intended as a checklist of all factors, appendix C to SAS no. 109 provides specific examples of risks for consideration. This list, plus other factors identified in the standards, may facilitate productive discussions during the brainstorming session. These factors have roots in business risks that in the past have led to audit issues.

It is expected that on every audit the auditor will identify one or more significant risks before considering related controls. For example, a significant inventory of precious metals or gems might be a significant risk in an audit of a jewelry business. In other businesses, such risks

EXECUTIVE SUMMARY

- **The new audit risk standards** require the auditor to understand and respond to risks of material misstatement, whether due to errors or fraud. In reaching that understanding, auditors should identify risks to the entity's business and the controls in place to mitigate them.
- **These standards use the more sharply defined** terms *must, should* and *may* from SAS no. 102, *Defining Professional Requirements in Statements on Auditing Standards.*
- **Because these standards address** many issues at the core of auditing, they may significantly affect the formality of the risk assessment process and documentation of the assessment details, depending on how this has been done in the past.
- **Entities and auditors will maximize** their effectiveness and efficiency if they carefully plan their responses to the new requirements. The documentation and assessment of controls over financial reporting is a good place for them to begin such efforts.
- **The AICPA is creating** a number of educational products designed to help auditors implement the new standards.

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may arise due to unique transactions, adjustments or critical accruals, such as the estimation of highly subjective allowances. For significant risks, the auditor should (1) consider the design and implementation of related controls, (2) avoid reliance on analytical procedures alone and (3) rely on evidence gathered only in the current period for controls assurance.

By their nature, some risks may have especially pervasive effects on financial reporting. For example, one risk may be associated with the weak business background of those charged with governance (that is, the owners or a group such as the board of directors). This type of overall risk can affect many accounts and measures, but others relate more to specific accounts and assertions. For example, a risk of misstatement of inventory amounts due to obsolescence risk in a line of inventory products would be related to the valuation assertion for that account.

Both these types of risks—overall and assertion-based—may affect auditors' actions and procedures, but in different ways. An overall audit risk might require a more experienced engagement team, while the obsolescence risk in inventory may require specific, directed procedures, such as a more detailed analysis of product demands and inventory turnover.

Linking Risks and Procedures

An important requirement in these standards is the need to link identified risks to relevant controls and to the audit actions designed to respond to these risks. Such a linkage helps the audit team determine whether the risks are addressed, assists in communication on the audit and helps reviewers, including peer reviewers, follow the implementation of the audit strategy.

In practice, simpler audits may accomplish this linkage through careful cross-referencing of audit documentation. For more complex situations, this linkage may be supplemented by a planning or engagement strategy memo or matrix.

In heightening the importance of using assertions to link risks, the standards also have revisited the assertions in the literature and expanded them to articulate presentation and disclosure issues. The specific assertions listed in SAS no. 106, *Audit Evidence* (see exhibit 2, below), do not have to be used if auditors employ assertions that are essentially equivalent.

Internal Controls

The auditor should have a basis for his or her assessment of controls, such as a review of the design of controls over significant accounts and assertions, and a confirmation they are in operation by a walk-through or observation. The auditor cannot default to a high control-risk assumption without performing the required elements of a controls assessment.

> As part of the risk assessment process, the engagement team should hold a brainstorming session to consider the nature and magnitude of possible misstatement risks.

Additionally, without some assurance that the information in the accounting system is being generated properly, there is no basis to rely on analytical relationships of accounts or other financial data that are stored within the system.

Auditors should assess how all five components of internal control over financial reporting relate to the entity being audited (see the Committee on Sponsoring Organizations of the Treadway Commission's [COSO] framework; **www.coso.org/key.htm**). This does not mean that auditors are required to test or rely on controls as part of their audit strategy, formerly referred to as the *audit approach*. But the auditor should assess the design of the controls and examine some evidence that the controls have been properly implemented on all audits.

Auditing standards focus on the controls over financial reporting, but COSO's 1992 *Internal Control—Integrated Framework* (**www.coso.org/publications/executive_summary_integrated_framework.htm**) also discusses regulation and operations. These other elements are relevant only if they affect financial reporting. For example, a failure to comply with regulatory requirements could affect contingencies or even the *going concern* assumption (see "COSO Framework—The Five Components," page 46).

How this requirement is implemented can have a significant effect on the entity's costs, particularly in the first year. For example, an auditor might evaluate whether the internal controls achieve the COSO control objectives and consider the risks of what could go wrong if the controls were ineffective. This evaluation should relate objectives, risks and controls by assertion to determine that all these elements

Exhibit 2 SAS No. 106 Financial Statement Assertions

Transaction	Balance	Presentation and disclosure
Occurrence	Existence	Occurrence and rights and obligations
Completeness	Rights and obligations	Completeness
Accuracy	Completeness	Classification and understandability
Cutoff	Valuation and allocation	Accuracy and valuation
Classification	–	–

are synchronized. Only significant accounts and processes would generally be addressed using this analysis. For example, controls over major revenue and expense streams would be assessed for most entities, but those over treasury transactions might not be assessed in an entity where such transactions are infrequent, not material, and will be fully validated by substantive procedures.

Evidence that a control has been implemented can be obtained in a walk-through that follows transactions from their inception through the aggregation process in the ledger. Alternatively, such evidence of implementation can be obtained by observing the operation of a control at the various stages of the control process—for example, at a specific time or over one or more specific documents, or by examining the sign-off of a control operation that verifies the agreement of an invoice with a list of approved vendors.

Smaller entities often have less formally documented controls. Also, in smaller entities it is easy to overlook the hands-on role some senior members of management may play in internal control, either in monitoring controls or in performing controls directly.

The use of control objectives or an equivalent, along with simple flowcharts that can be related to the objectives, often may provide more efficient documentation than narratives or complex flowcharts. Phasing in the development of efficient documentation today, prior to the effective date of the standards, can save audit time and expense (see "Control Objective Based Documentation," below).

COSO's October 2005 draft report, *Guidance for Smaller Public Companies: Reporting on Internal Controls over Financial Reporting*, suggested that using control principles in conjunction with other sub-attributes can be an efficient documentation framework for smaller companies. Whether companies or auditors use the original COSO control objectives, or some variation at a higher level of aggregation of the objectives, the end result should be the same. The auditor should be able to identify control design gaps that could have significant consequences for the entity.

Simply using checklists of possible controls to identify design deficiencies or missing controls may be inefficient because they may incorrectly lead to the expectation that all controls on the list are needed to achieve the entity control objectives. Explaining how the entity achieves the relevant control objective and mitigates the related risk can make the documentation more effective and efficient.

Identified significant deficiencies and material weaknesses must be reported to management and those charged with governance. The ASB recently approved SAS no. 112, *Communicating Internal Control Related Matters Identified in an Audit* (see Official Releases, page 97), a revision of SAS no. 60, *Communication of Internal Control Related Matters Noted in an Audit*, to define the auditor's responsibility to do this.

Because of the need to assess controls, including information technology (IT) general controls, some auditors may need to engage a specialist to assist in the assessment process, especially when the IT environment is complex or the auditor expects to rely on automated controls and has limited resources to address the issues. When the auditor's strategy is to significantly rely on some or all of the entity's controls, they should be tested. The next article on this topic will discuss testing controls more fully.

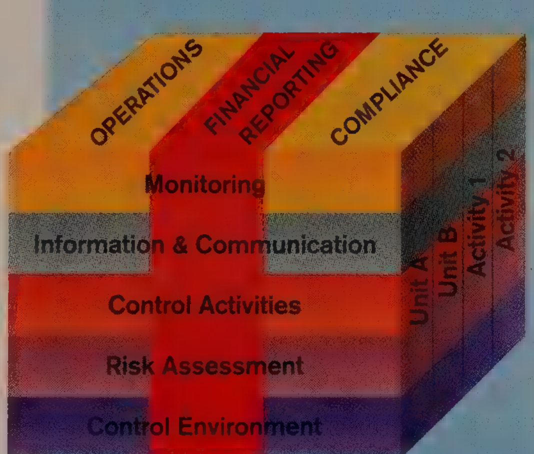
The minimum design and implementation work can provide some basis for varying the nature, timing and extent of the procedures planned. That is because the procedures that confirm implemen-

Why and How Guidance Has Changed

The eight audit risk standards, SAS nos. 104–111, respond to the conclusions of the Joint Risk Assessments Task Force of the ASB and the International Auditing and Assurance Standards Board and to recommendations of the August 2000 report of the Panel on Audit Effectiveness of the Public Oversight Board and consider the results of "Developments in the Audit Methodologies of Large Accounting Firms," a May 2000 study of audit practices in three countries.

These standards, originally exposed in December 2002, were re-exposed in 2005 after further refinement. They use the more sharply defined terms *must*, *should* and *may* from SAS no. 102, *Defining Professional Requirements in Statements on Auditing Standards* (see "Official Releases," *JofA*, Mar.06, page 94). The eight standards were published in "Official Releases," *JofA*, May06, page 112.

COSO Framework–The Five Components



Control Objective Based Documentation

- ***Control objective***

Sales are valid.

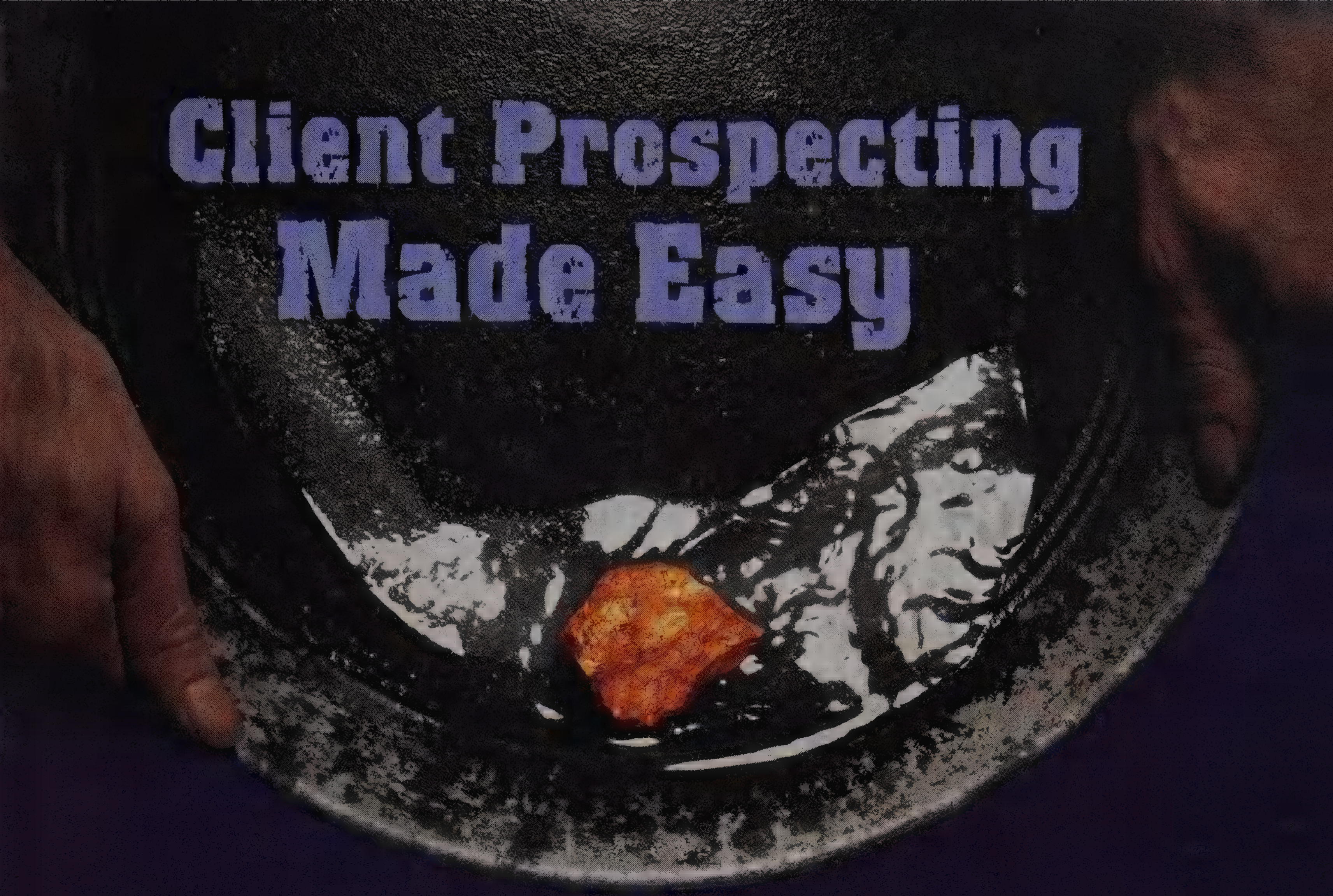
- ***Risks***

Because of credit-card fraud, the transaction may not produce revenue.

- ***Assertions***

Occurrence: Did a valid sale occur?

- ***Company controls***
  - Pre-sale credit card validation is in place.
  - Close monitoring of past defaults.
- ***Assessment***
  - The control design is effective.
  - A walk-through of procedures confirmed these controls are in place.
  - Reference to other supporting workpapers (not illustrated).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tation also may provide some evidence of operating effectiveness at the time the test is conducted. For example, some auditors refer to a walk-through as a *test of one* that—if it is the only evidence gathered—is a minimal basis for any reliance. However, the assurance that can be placed on controls is a continuum based on the evidence that was gathered to support the assessment that controls are operating effectively.

The requirement to assess controls for audit purposes should not be confused with the attest service of reporting on internal controls. Such engagements would likely involve the assessment of controls over more processes and accounts, assume a significantly greater amount of documentation of controls by the entity and require testing by the auditor when opining on effectiveness.

RISK OF MATERIAL MISSTATEMENT

This is the combination of the assessments of risks and related controls. Auditors may assess these two risks together or separately, although, for practical reasons, the components often are assessed separately. The risk of material misstatement forms the theoretical starting point for designing further audit procedures including tests of controls, analytical procedures and tests of details.

WHAT'S NEXT

The AICPA is creating a number of educational products to help auditors implement the new standards, including a recently issued audit risk alert, *Understanding the New Auditing Standards Related to Risk Assessment*, and an audit guide, as well as presentations and discussions on the topic at a number of AICPA conferences and new CPE courses.

A second article on this topic will discuss designing further audit procedures, the process of summarizing audit results and drawing conclusions. ❖

AICPA RESOURCES

CPE

Auditor's Risk Assessment Process: Tackling the New Risk Assessment SASs (text, # 732990JA; DVD/manual #182990JA).

Publications

- *Risk Assessment Suite of Standards* (paperback, # 060704JA).
- *Codification of Statements on Auditing Standards* (paperback, # 057200JA).
- Audit Risk Alert, *Understanding the New Auditing Standards Related to Risk Assessment* (paperback, # 022526JA).
- *Risk Assessment Standards & Guidance Set* (paperback, # 990103HIJA).

For more information or to place an order, go to **www.cpa2biz.com** or call 800-777-7077.

Web site

- Summary of the eight audit risk assessment standards, SAS nos. 104–111, **www.aicpa.org/risk**.

» Practical Tips

- Study the concepts of the COSO internal control framework now and be familiar with its components and how it applies to clients.
- If you have another audit cycle between now and the effective date of these standards, consider control risks more thoroughly and the documentation that will be necessary to support your audit under the new standards.
- Be alert for the "smaller companies" guidance expected to be forthcoming from the COSO project in the second quarter of this year. Identify cost- and effort-saving opportunities to apply this guidance and assist clients in strengthening controls.
- Consider whether the audit has addressed all of the relevant assertions for all important accounts and transaction streams. Pay attention to any practice aids that employ assertions, and learn how they can be used to build a link between the risks and audit procedures.
- Start now to build "assertions-based" terminology into engagement team discussions to generate familiarity.

A Strategic Player

Hiring and inspiring a chief audit executive.

by Larry E. Rittenberg and Richard J. Anderson

Internal audit traditionally has been a behind-the-scenes player, helping audit committees perform their duties and serving as a management watchdog. But today it plays a vital role in efforts to improve corporate governance and internal controls. To fulfill this role, the chief audit executive (CAE) needs to provide assertive leadership that strengthens the organization's commitment to tough internal controls. CAEs must partner with senior management and the audit committee to help them fulfill their broad responsibilities for effective governance, risk management and control. This article offers a broad view of the skills and qualifications CAEs need and information that management and audit committees will find useful when filling this critical position.

Audit committees, whose governance responsibilities have expanded significantly since the Sarbanes-Oxley Act, are turning to internal audit for strategic and tactical support. The same is true for senior management. PCAOB Auditing Standard no. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*, has sharpened the focus on the internal audit function and its ability to help senior management, audit committees and external auditors achieve their reporting objectives. At the same time, internal audit cannot sacrifice its long-standing role in promoting risk management and using operational audits to improve organizational efficiency.

The Ideal Candidate

When hiring a CAE, companies should look for someone who combines strong management and leadership skills with solid technical expertise. This ideal candidate is more than just a technical auditor. When looking for a new audit chief—or evaluating the performance of an existing one—the audit committee and senior management should focus on three critical qualifications:

CAE Technical Qualifications

In addition to executive-level interpersonal skills and solid business judgment, most companies are looking for these qualifications in a CAE candidate:

- At least 10 years of relevant management experience with an accounting firm and/or a similarly sized company.
- CPA and/or CIA designation.
- Strong technical accounting and auditing skills.
- Internal audit expertise.
- Knowledge of Sarbanes-Oxley and PCAOB, FASB and SEC pronouncements.
- Deep understanding of the industry and related business risks.
- Track record of leadership and ability to stand behind tough decisions.

ILLUSTRATION BY JANET ATKINSON/IMAGES.COM/CORBIS

The candidate's ability to earn the respect of the audit committee and senior management. Because internal auditors must be comfortable operating at a strategic level, a CAE must be perceived as a trusted adviser to both the audit committee and senior management. However, because internal control goes beyond financial reporting, operational managers need to accept internal audit as leaders in addressing risk and governance in a way that goes beyond mere policing and testing of internal controls. Sample questions to ask a candidate: In what kind of situations have you advised management or the audit committee on a strategic issue? How would you reconcile the sometimes divergent roles of auditor and adviser? What activities would you initiate to position yourself as an adviser to the audit committee?

The range of skills, including personal independence and objectivity. An effective CAE needs to demonstrate a solid understanding of the company's business, core strategies, risk appetite and risk tolerances. He or she must be able to exercise sound business judgment and partner effectively with senior management while at the same time remaining both independent and objective. The need for independence and objectivity is fundamental. CAEs must be willing to raise difficult issues with both senior management and the audit committee, even if that proves unpopular. To gain management respect, CAEs must make tough calls and stand by them. However, CAEs who describe all issues as *significant* will quickly lose support.

While auditing often is correctly viewed as a technical function, the softer audit skills are equally critical. Interpersonal skills are particularly important in building effective working relationships with management and the audit committee. CAEs must be able to think strategically about the internal audit function, its mission and its strategic resources, including attracting highly qualified staff. CAEs must have a vision for the internal audit function that accepts change as part of an ongoing process throughout the organization. Staffing must mirror the critical issues the organization faces and often requires sophisticated and knowledgeable audit staffs to address the company's risks effectively.

> One of the chief attributes of effective CAEs is the ability to attract and develop talent and to build a high-quality staff whose members can work effectively in teams.

One of the chief attributes of effective CAEs is the ability to attract and develop talent and to build a high-quality staff whose members can work effectively in teams. In many organizations internal audit also serves as a source of management talent for other departments. To help the CAE perform this sourcing role, it's important to make it clear he or she functions as a member of top management. Sample questions to ask a candidate: What is internal audit's role in an organization? Can you describe a situation where you raised a critical issue to management and how you handled it? How would you partner with management while maintaining your independence and objectivity? What approach would you take to attract and develop high-quality staff?

The right focus. The strategic CAE also must take the lead in advising the audit committee on emerging risk and control issues. In recent years two key factors—the passage of Sarbanes-Oxley and the implementation of reform legislation—have focused audit committee attention on financial risks. However companies face many additional risks and audit committees are becoming more sensitive to enterprise-wide risk. As a result, internal audit must look more broadly at risk to help the audit committee understand the risk-monitoring and mitigation activities the company already has in place and the effectiveness of its overall risk management

AICPA RESOURCE

AICPA Audit Committee Toolkit
Guidelines for Hiring the Chief Audit Executive (CAE)
www.aicpa.org/audcommctr/toolkitsnpo/Hiring_CAE.htm.

EXECUTIVE SUMMARY

- **Many companies are raising the expectations** for their chief audit executives (CAEs) to include operating at more strategic levels of risk management and corporate governance. Successful CAEs must partner effectively with the audit committee and other members of the senior management team to achieve their objectives.
- **To be effective, CAEs need to demonstrate** a solid understanding of the company's business, core strategies, risk appetite and risk tolerance. CAEs must be willing to raise difficult issues with senior management and the audit committee—even if such actions prove unpopular.
- **The CAE should maintain an ongoing dialogue** with the audit committee. This will build a relationship and help the committee stay on top of significant risk and control issues.
- **One of the chief attributes of an effective CAE** is the ability to attract and develop talent and build a high-quality staff. In many organizations internal audit is a source of management talent for other departments.

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processes. Sample questions to ask a candidate: How would you assess the risks the organization faces? Are you familiar with the COSO enterprise risk management framework and how would you apply it? How would you use technology to enhance your ability to monitor risks? How will you help the audit committee be aware of emerging risks?

In part, the CAE's role is a balancing act: He or she must simultaneously serve as the eyes and ears of the audit committee as well as be a member of and partner to executive management. To serve both parties effectively, CAEs must be seen as business partners rather than "corporate cops." To be an effective extension of the audit committee, CAEs need to maintain an open and objective view of management, be seen by it as fair and respect the opinions expressed. On the corporate side, CAEs need to gain the respect and confidence of executive and operational management as a prerequisite to being viewed internally as a member of senior management and being included in meetings that address risk and strategy across the organization.

Additional Things to Consider

Here are some key questions to which management and audit committees need to get satisfactory answers when considering CAE candidates who can help the internal audit group adopt a more proactive role in risk management and governance. In candidate interviews and in discussions with their references, companies should use probing questions to develop an understanding of whether the candidates have

- The presence and experience to fit into the management ranks at the appropriate level.
- The knowledge and business sense required to serve as a trusted adviser to both senior management and the audit committee.
- A track record of sound judgment and decision making.
- A sufficient understanding of the business and its risks to ensure the audit process is properly focused and responsive to risk.
- The personal strength and confidence to stand up to and earn the respect of senior management.

Once on Board

After an organization has hired a high-caliber CAE, the audit committee and top management can do much to enhance his or her stature and effectiveness. Supportive steps for the audit committee chair, in particular, to consider are

- ***Maintaining ongoing access and dialogue with the CAE outside audit committee meetings.*** Such communication strengthens the bond between the audit chair and the CAE and helps the committee stay on top of significant risk and control issues.
- ***Asking senior management to attend an audit committee meeting to address issues the CAE raises.*** Such a request reinforces the significance of the issues and emphasizes that responsibility for resolving the issues lies with management, not the CAE.
- ***Including the CAE in appropriate committee activities, such as training.*** In some organizations, audit committee members and the CAE attend joint training and conferences to identify new practices or approaches and to strengthen working relationships.
- ***Periodically meeting with the CAE's direct reports or the entire audit department.*** Such meetings give internal audit staffers first-hand exposure to audit-committee concerns and give audit committee members a better appreciation of staff quality.
- ***Holding executive sessions with the CAE.*** Such interchange ensures an open exchange of views on issues and risks identified by the CAE and management's response.

> The CAE's role is a balancing act: He or she must simultaneously serve as the eyes and ears of the audit committee as well as be a member of and partner to executive management.

Adopting a Strategic Mind-Set

Once a company has a CAE in place, it's time for the CAE and the audit committee to make sure internal audit has adopted a strategic, high-level mind-set as opposed to a tactical orientation that focuses on basic transactional or compliance issues. To assure this is happening, there are some key questions the audit committee should ask, including

- Does internal audit's risk assessment include the significant risks the company faces and is the audit plan directly linked to those risks?
- Does management view the issues internal audit is raising as significant and give them proper attention?
- Is the CAE conversant and involved with the company's developing business issues and initiatives?
- Does the CAE understand our business, its strategies, our expectations and

Practical Tips

- Make sure the CAE candidate you hire fits into the management ranks at the appropriate senior level and has the necessary high-level knowledge to be a trusted adviser to both senior management and the audit committee.
- Maintain ongoing communications with the CAE, including activities outside normal meeting such as joint training sessions with audit committee members.
- Have the audit committee meet regularly with the CAE's direct reports and hold executive sessions with the CAE to ensure an open assessment of issues and risks.

those of senior management, so internal audit can respond effectively?

■ Is the audit plan sufficiently responsive to emerging risks and changes in the organization's risk profile?

■ Are the company's internal audit activities being conducted in accordance with the Institute of Internal Auditor's International Standards for the Professional Practice of Internal Audit?

If the answer to any of these questions is "no," the CAE, the audit committee chair and top management should meet to make sure all parties understand what the company expects and come to an agreement on a strategy for meeting these expectations.

The Right Person for The Job

Audit committees and senior management can optimize the value a company gets from internal audit by putting a well-qualified CAE at the helm. Recent regulatory changes have focused some internal audit functions on narrower compliance-oriented activities, endangering their ability to contribute to effective governance and risk management. Organizations must make sure they have a clear, strategic vision of internal audit and a CAE with the right skills and stature to implement that vision. They need to consider a CAE's qualifications carefully, paying particular attention to skills beyond just technical ones. The organization also must evaluate the effectiveness of the CAE and the audit function in a manner consistent with its strategic expectations. The exhibit below provides an example of a framework companies can use as a starting point to develop their own expectations. ❖

Exhibit Key Performance Criteria for CAEs

The audit committee and executive management should make certain they have a common view of the criteria for evaluating the CAE's performance. While each company's list will be customized, here are some key areas to consider in developing a framework.

Stature and presence

The CAE must have the professional presence and stature to function as a trusted adviser. The CAE should develop and maintain strong relationships internally with executive and senior management, and externally with the audit committee, board, regulators and external auditors. The CAE must maintain continuous and proactive communication with all key constituents while keeping an appropriate level of objectivity and independence. The CAE also must have the personal strength to make tough calls and stick by them.

Strategic audit focus

The CAE should develop a vision for a strategic internal audit process, addressing the key business strategies and risks to the organization. Strategies should align the audit coverage with risks, including identifying and reacting to emerging risks and issues. The CAE should have a strong knowledge of industry/peer audit practices. The CAE must be capable of operating and viewing issues at a strategic level.

Ability to exercise sound judgment and communicate clearly on audit issues

The CAE should exercise sound business judgment, prioritize issues and make sure they are handled at the appropriate level. The CAE should raise and communicate in a timely and clear manner significant issues to the audit committee and management with recommendations as to which deserve their immediate attention. The CAE should maintain an appropriate process to ensure the company takes corrective actions in a timely manner.

Development of human resources

The CAE should attract and develop talent for the internal audit function and the organization as a whole, and create an environment in which internal audit is viewed as a desirable assignment for the long term. Internal audit's activities should be aligned with the organization's overall human resources strategies to optimize the employees' experiences. The environment also should foster a culture that enables the internal audit function to fulfill its role and add value to the organization.

Management of technical auditing activities

The CAE should ensure the company's audit plan and other critical audit initiatives are being conducted in accordance with applicable professional standards and reflect current business risks and audit requirements as well as emerging industry trends. For critical transactions and initiatives, the CAE should ensure the financials properly reflect the economic substance of the activity. The CAE should ensure the internal audit function has access to appropriate resources and technical skills to execute its mandate.

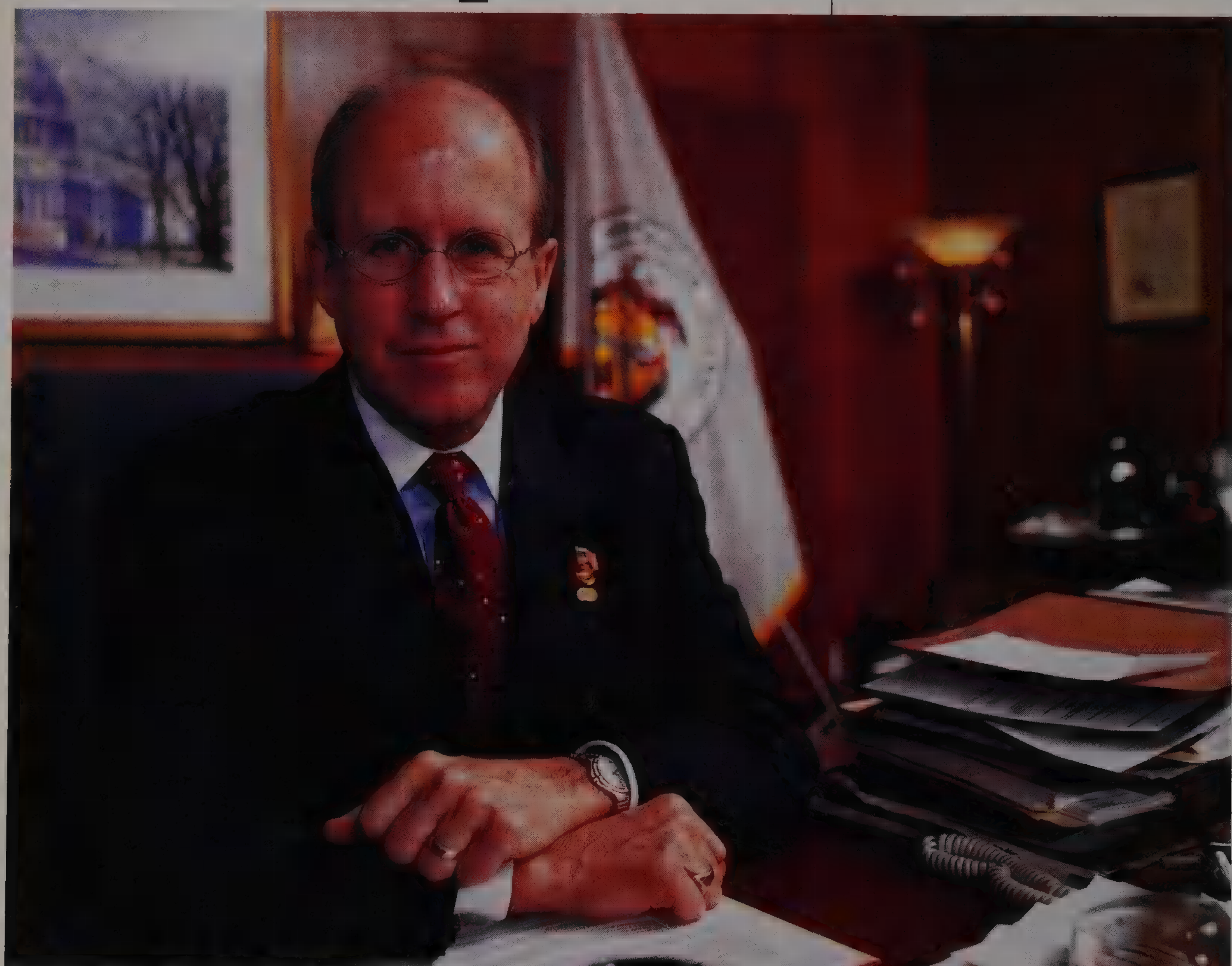
Understanding of the organization's strategy

The CAE should make sure the organization understands and addresses its risks. Sometimes the biggest risk is the failure to innovate. A CAE must understand the organization's strategy, how it will measure performance in following those strategies and how to overcome any roadblocks.

Enhancing Public Confidence: The GAO's Peer Review Experience

Even auditors need to be audited.

by The Honorable
David M. Walker,
Comptroller General of the
United States



PHOTOGRAPH BY DENNIS BRACK/BLACK STAR

The peer reviewers recognized our successes in compliance and quality control and suggested ways to strengthen guidance and streamline procedures. This experience more than repaid our investment in it.

In 2004 we at the Government Accountability Office (GAO) arranged to have a multinational team of experienced performance auditors conduct the first-ever peer review of our performance audits of federal government programs (**www.gao.gov/peerreviewrpt2005.pdf**). We also hired KPMG LLP to conduct a peer review of our financial audit practice—their fourth such engagement with us. Both audit teams concluded that during the period reviewed the GAO's quality assurance system was suitably designed and operating effectively to provide reasonable assurance of conforming to applicable professional standards. The international peer review team also said that other national audit offices may want to emulate several of our practices and made suggestions that further enhanced our practice and provided other significant benefits. According to the reviewers, "[the] quality assurance system reinforces the GAO's independence, objectivity and reliability." These reviews inform Congress of and give the American people confidence in the quality of our financial and performance audits.

Origin and Mission

The GAO is part of the legislative branch of the federal government and thus is independent of the executive branch. Congress established the GAO in 1921 to investigate all matters relating to the receipt, disbursement and application of public funds. Since then, Congress has expanded the GAO's statutory authorities and frequently calls upon it to thoroughly examine federal programs and their performance, conduct financial and management audits, perform policy analysis, provide legal opinions, adjudicate bid protests and conduct investigations. In 2004 the GAO began work on nearly 800 performance audit engagements and issued more than 1,000 audit products. In fiscal year 2005, the GAO produced an $83 return on each dollar invested in our agency.

How to Do It Better

The peer reviewers identified the following as GAO better practices:

- Use strategic planning to focus on and respond to significant issues and management challenges.
- Conduct audit risk assessments to identify risk levels and determine the appropriate level of product review and management involvement.
- Establish agency protocols (see www.gao.gov) that explain what agencies can expect from the GAO during the audit and what the GAO expects from them.
- Use experts to conduct innovative analysis of complex situations.
- Employ the Electronic Assistance Guide for Leading Engagements (EAGLE) that helps GAO staff better manage their engagements by giving them immediate access to the policy, procedural and documentation requirements of the quality assurance system.
- Tailor audit report designs to the needs of readers with varied interests.

Under the Microscope

A team of 16 experienced performance auditors from seven countries reviewed our performance audit practice. The Office of the Auditor General of Canada led the multinational team. Other participants included national audit offices in Australia, Mexico, the Netherlands, Norway, South Africa and Sweden. The KPMG team consisted of experienced financial audit partners and managers with extensive government financial auditing experience.

The review teams focused on the elements of our quality assurance system dealing with engagement performance and compliance monitoring. They reviewed our audit policies and process controls, examined a representative sample of our 2004 audit engagement files and reports on government programs, and interviewed senior managers and staff responsible for selected engagements. They also evaluated our internal inspection program, including a representative sample of engagement files that our internal inspectors had examined in 2004 to determine whether their findings were supportable.

The performance audit team followed government auditing standards (the Yellow Book) and conducted the review in a manner consistent with the code of ethics and standards issued by the International Organization of Supreme Audit Institutions.

The review team's ultimate objective was to determine whether the GAO's system of quality controls provided reasonable assurance that our work is independent, objective and reliable. The financial audit team followed the applicable AICPA peer review standards as well as government auditing standards.

Good Marks

A key organizational and operational benefit of the peer review was the reviewers' confirmation that some of our key overarching quality control procedures are global better practices (see "How to Do It Better," at left). According to their report,

Dividends Earned

The GAO's peer review

- Provides assurance to Congress and to the American people that the GAO's work is objective, independent and reliable.
- Helps the GAO meet government auditing standards.
- Provides assurance to the Comptroller General and to senior GAO executives that the GAO is fulfilling its responsibilities and complying with requirements.
- Demonstrates that the GAO itself is accountable.
- Documents the GAO's Quality Assurance Framework.
- Enables the GAO's staff to learn from others.
- Is a source of pride for GAO staff.
- Improves policies, forms, guidance and training.
- Increases the staff's knowledge of standards, policies, guidance and better practices.
- Enhances the GAO's quality control system.

those practices help ensure that we focus our efforts on factors that affect government performance, that we assign engagement resources according to risk, that we develop complete and reliable evidence, that our engagement teams have the guidance and diagnostic tools necessary to perform their work and that our reports are clear, persuasive and fair.

The reviewers also said that the GAO could improve its performance audit practice by, for example, enhancing the transparency and efficiency of its quality assurance system and policies. We have implemented some of these recommendations, and we are testing others (see "Dividends Earned," page 57).

A Plan for Excellence

The GAO's approach to quality assurance was based on applicable professional standards and the agency's core values of accountability, reliability and integrity and it ends with public dissemination of virtually all its products. We had already created a quality assurance framework (see the exhibit below) to summarize the policies and procedures we use to ensure compliance with professional standards and our core values. It applies to both performance and financial audits. The framework focuses on staff, processes and technology. It addresses leadership, human capital, engagement performance, monitoring and policy review by defining the roles and responsibilities of key participants, key control objectives and relevant procedures, and by providing links to online references. At the framework's core is a standardized, decision-based engagement management process that ensures consistency in the application of key controls. The framework also includes monitoring and assessment by both internal and external entities, and mechanisms for continuous improvement.

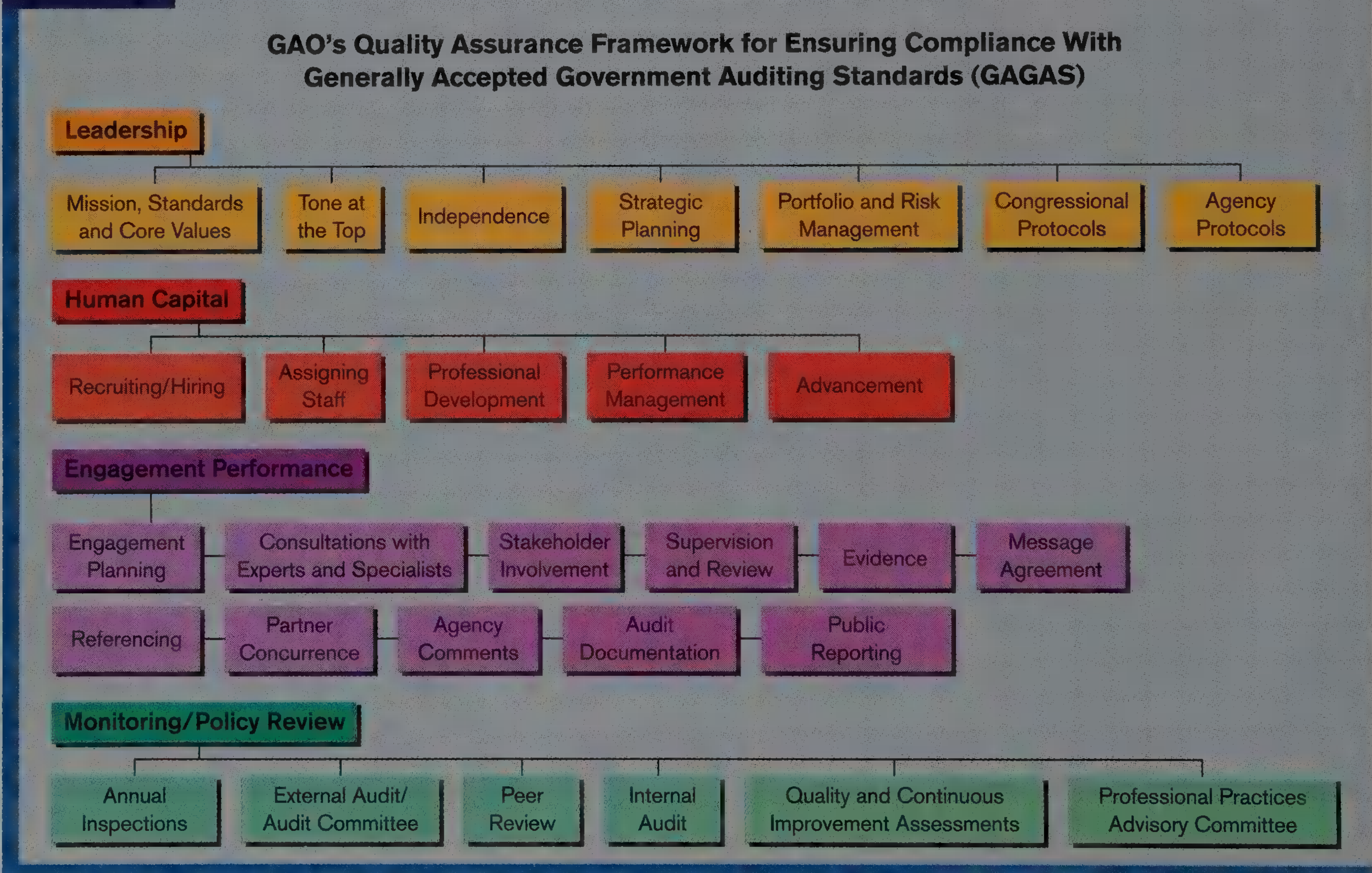
The Key to Quality Control

The GAO has long had a rigorous internal quality control program that annually reviewed a sample of work from every part of the agency for compliance with policies and procedures. These reviews evolved into our current inspection program, which the peer reviewers recognized as a comprehensive, effective assessment. The development of this rigorous inspection program took several years, but its results have helped enhance training, reform policies and improve audit tools. We also had improved our methodology for conducting the inspection by designing checklists and other tools to facilitate it and had developed a staff with the expertise to conduct inspections.

Ideas for Improvement

The peer reviewers also made the following suggestions:

Exhibit The GAO Quality Assurance Framework



■ Distinguish between audit and non-audit services. Provide additional guidance on what kind and extent of evidence is appropriate for each form of service, and explain when it is appropriate to consider changing an audit determination in view of newly obtained evidence.

■ Provide additional details on the sources of critical audit-related information and the implications of choosing a particular audit scope and methodology.

■ Review the quality assurance system to see whether we can improve it.

■ Streamline the audit documentation requirements.

■ Increase the efficiency of the inspection program.

It Works for Us

Although peer review is a lengthy and costly process, it enables us to better inform stakeholders of our activities and their results. For example, in accordance with government auditing standards we share the peer review reports with our oversight committee. We also make them available to the public on our Web site (**www.gao.gov/aac.html**) and refer to them in our annual performance and accountability report and testimony to Congress.

In addition to promoting the public interest, peer review helps an audit organization understand whether its practices comply with professional standards and how they compare with those of other entities and with new practices. For us, the chief benefit was confirmation of our compliance with government auditing standards. As an organization in constant pursuit of improvement, we also benefited from the peer reviewers' recognition of our quality control procedures as global better practices as well as their suggestions on how to strengthen guidance and streamline procedures. These positive results have more than repaid the time, money and effort we've put into peer review. ❖

AICPA RESOURCES

CPE
"Peer Review: Are You Ready?" (text, # 731692JA).

***JofA* Article**
"Peer Review Is Stronger and Better Now," *JofA*, Apr.05, page 44, **www.aicpa.org/pubs/jofa/apr2005/jentho.htm.**

Online Center
Center for Public Company Audit Firms Peer Review Program, **www.aicpa.org/centerprp/peer_review.htm.**

Publication
AICPA Peer Review Program Manual (loose-leaf subscription, # QR-XXJA).

For more information or to place an order, go to **www.cpa2biz.com** or call 888-777-7077.

David M. Walker, CPA, is comptroller general of the United States and heads the U.S. Government Accountability Office.

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AICPA 3791

The Small Firm Advantage

Does your firm have it?

by James C. Metzler

Challenges and limitations face many small businesses, including CPA firms. But despite their modest size, local practices have considerable advantages that give them a competitive edge in recruiting, retention, client service and other vital areas. Because I worked in small CPA firms for more than 30 years, I see those advantages clearly.

At the AICPA Private Companies Practice Section (PCPS) we think it's time to help our members focus on ways to make their size work for them. Accordingly, PCPS is undertaking many new efforts to provide insight and support for our small firm members and is rededicating itself to initiatives and publications that highlight the small firm advantage. With our new small firm logo (at right), members can quickly locate those resources. This article describes how many small firms are using size to their advantage.

COMPETITIVE EDGE

What is the small firm advantage? It is the flexibility, collegial atmosphere, opportunities to be hands on and grassroots ingenuity that give a smaller practice an edge in facing management challenges that include the following:

Recruiting. In the ongoing scramble to find new talent, small firms can stand out from the crowd by being more responsive and personal. At 30-person Wilkins Miller PC in Mobile, Ala., partner Michael Kintz, CPA, says, "Many new hires find us because a staff member told someone about our firm's family atmosphere."

Small firms that bring satisfied staff members into the recruiting process have a clear advantage. For example, at 20-person Millikin Benning Kleckler & Kobischka LLC in Rockford, Ill., and Monroe, Wis., a talented young CPA was weighing whether to take a job in the Rockford office or with a national firm. "Because the candidate said she planned to start a family soon, we sensed she was very interested in flexibility," says partner Curt Kleckler, CPA.

The firm invited her to talk to new mothers on staff to get direct information and reassurance about the firm's capacity to accommodate flexible schedules. Kleckler believes she elected to join his firm in part because the people who ultimately would make decisions about her future schedule used flextime themselves and understood her situation.

Retention. Once a firm attracts talented employees, what's the best way to hold on to them? Find out what they want and make them feel valued. That often is easier to do in a small environment. "Some people want time off, while others appreciate a casual business atmosphere or firm outings to baseball games," says Kintz. Employees feel like part of the firm when senior members are genuinely sociable and friendly and let them know that having good staff is a big part of what makes the business successful. A small firm can give that personal attention.

Small firms also encourage firm members by participating in their lives in good times and bad. "We attend colleagues' family weddings and funerals," says Kintz, and really reach out to someone going through tough times. That unity is reflected in a low turnover rate. During a recent three-year stretch, the firm lost only one professional while it added four.

Ambitious staff members get great opportunities in small practices, too, says Bruce C. Smith, CPA, managing partner of 25-person Mather & Co., Louisville, Ky. He observes that in the largest firms it's rare for a partner to accompany a staff member on fieldwork, but practices like his accommodate that regularly. Big-firm staff members generally are assigned only a few engagement tasks and don't get a broad sense of the client's business. In a small firm,

Use the PCPS small firm logo to quickly locate helpful resources.

when a junior staff person goes out in the field with a partner, it's an opportunity for him or her to take part in the interaction and get to know the client better.

Staff members who don't crave a management position can find challenging work in small firms as well. "Public accounting is a great place to be, but not everybody wants to be an owner," says Kintz. "At a smaller firm it's easy to identify staff members' strengths and understand how they can contribute without getting on an ownership track."

Work/life issues. "Women are gravitating to smaller firms where they represent 47% of the workforce, compared with 40% at larger firms," according to "A Decade of Changes in the Accounting Profession: Workforce Trends and Human Capital Practices," a new study by the AICPA's Work/Life and Women's Initiatives Executive Committee. Women find it easier to advance at small firms, and that's encouraging since they continue to enter the profession in high numbers. And of course work/life flexibility is not important just for women. The study found that more than 75% of professionals of both sexes at all levels showed great concern about maintaining a work/life balance.

Adaptability—the foundation of any work/life balance program—often is simpler to achieve in a local practice where there's less bureaucracy and it's easier to customize programs for individual firm members. "If you find people you think can do the job, be as flexible as you can in meeting their needs," Kleckler says. "When somebody comes into my office and makes a special request, I try never to say no." His strategy is to hire people with strong skills and a good work ethic, then adapt to their needs. "If they want to take a week off in filing season, and they think they can make it work, you really can't refuse."

In addition, many staff members choose small firms because they don't want to spend a great deal of time on the road. "We serve the local market, and the resulting lack of travel appeals to recruits," Kintz says.

Client service. From a client standpoint, "the biggest advantage in a small firm is the involvement of management," says Kintz. "There are typically at least two people involved with a client, one of whom is a stakeholder, plus a manager or another staff person. The clients work with decision makers in the firm."

Smith notes that a common complaint at some firms is that clients are not sure who's in charge of their account and whom they're supposed to call when they need help—the senior manager, partner or someone else. "Our clients are cottage industries, family businesses. Some have worked with our firm for 30 years, even after the business was passed on to a new generation. They want to know they have a familiar person at the firm as a contact when they reach out."

Kleckler has a basis for comparison; he was with a large firm for 11 years, where he rose to the level of senior manager. His clients were large companies with their own CPAs and other qualified people on staff, so the kinds of questions they asked him were much different from those a small practitioner typically would get. "The clients we deal with rely on us more for basic, day-to-day questions, and they need an answer right away."

Streamlined Management

Practitioners also point out the advantages of smaller practices for firm leaders. It's easier to feel like an owner in a small firm, says Kleckler. "At a larger firm, even if you're a partner, you're pretty much an employee. You're not given a lot of decision-making responsibility." In a smaller practice, however, even staff and administrative personnel are aware that decisions are made on-site. "If staff members have an issue or a question, they know they can get an immediate answer, or at least talk to someone about it right now. They don't have to wait to send to the New York home office for a response."

Kintz also notes that some procedural changes are easier to make in a smaller environment. When his firm decided to go paperless it hired a larger firm to help with the project. The consulting firm had a number of offices and its representatives told Kintz that they had firsthand knowledge of the many problems of going paperless. But for Kintz's firm the problems were few and the change was relatively easy. When things came up, they ironed them out in weekly staff meetings. "We got together to talk about what worked and

EXECUTIVE SUMMARY

- **Despite their modest size,** local practices have many real advantages that give them a competitive edge in recruiting, retention, client service and other vital business areas. PCPS is undertaking many new efforts to support its small firm members, and is rededicating itself to initiatives and publications that highlight the small firm advantage.
- **That advantage stems from** a smaller practice's flexibility, collegial atmosphere, opportunities to be hands on and its grassroots ingenuity. Senior members who are genuinely friendly and let employees know that having good staff is a big part of what makes them successful offer tremendous encouragement to firm members in good times and bad.
- **Ambitious staff members** get more opportunities in small practices. At the same time, staff members who don't want to advance to management level still can find challenging work. Many employees choose small firms because they don't want to spend a lot of time on the road, but the biggest advantage is the involvement of management in the work process. Typically clients work with decision makers in the firm.
- **Women find it easier to** advance at small firms, which is encouraging since they continue to enter the profession in high numbers. But work/life balance continues to be a priority for talented professionals of both sexes and at all levels.
- **From a partner's point of view,** it's easier to feel like an owner in a small firm. At a larger firm, even partners feel like employees.
- **Small firms don't have to** change what they're doing or try to be more like large firms. They simply have to recognize all the good they have going for them and reinforce it, both inside and outside the practice.

James C. Metzler, CPA, is AICPA vice-president, small firm interests.

what didn't. When you're small, it's easier to capitalize on efficiencies."

Kintz also believes that smaller firms benefit from focusing on productivity rather than on hours worked. "When you have a real sense of what people are doing, you have a better idea of who needs help and who can take on more work."

Despite the firm's size it does have a person who works as a marketing and recruitment coordinator—two functions that often dovetail. It constantly tries to stay informed about people who are available in its market, so that if a client calls and mentions it needs someone—from a bookkeeper to a CFO—the firm just may have a resume on hand that fits the bill. "In a smaller environment, when you have one person wearing two hats, you can maintain that sense of who's out there. As a result, we often can provide a service that makes us a resource for clients."

A New Perspective

Small firms don't have to change what they're doing or try to be more like large firms. They simply have to recognize all the good they have going for them and reinforce it, both inside and outside the practice (see "Accentuate the Positive," at right).

"We definitely try to press our small firm advantage in marketing and recruitment efforts," says Smith. The managing partner makes an effort to meet with all new or prospective clients to reinforce the fact that if the partner a client works with is not available, the client can call the managing partner. "We want clients to know they can count on that benefit when working with our firm."

In a competitive environment in which high-quality work is the norm, what differentiates one small firm from another may be only price or service. Smith believes those offering the best service will win. "That hands-on approach is second nature at small firms."

I hope this article will help small firm readers maximize the many advantages they possess. In offering big rewards to their staff and their clients, small firms get practice development opportunities that capitalize on their special strengths. ❖

Accentuate the Positive

Have your staff and partners answer the questions in this checklist to make the most of your small firm advantages.

- ❑ Why are we proud of our firm? What are its most important assets?
- ❑ What would we want prospective staff members to know about our firm?
- ❑ What would we like prospective clients to know about our firm?
- ❑ Why is this a good place to work? How would staff members describe the firm?
- ❑ Why do clients like our firm? How would they describe our services and client service?
- ❑ In what ways is our size an advantage?
- ❑ How can we use our advantages to enhance our services, client relationships and staff satisfaction?
- ❑ Given the answers to the previous questions, how would we market our firm to a promising young recruit? To a potential client?

AICPA RESOURCES

CPE self-study courses

- AICPA's Guide to Financing the Growing Small Business: Sources, Strategies and Disclosures (# 730483JA).
- AICPA's Guide to Reporting and Disclosure Problems for Small Businesses (# 734334JA).
- Analytical Procedures for Small Business Engagements (# 730551JA).
- Innovative Tax Planning for Small Businesses: Corporations, Partnerships & LLCs (# 745518JA).
- Marketing: Successful Strategies for CPA Firms, DVD/manual (# 181831JA), VHS tape/manual (# 181830JA), additional manual (# 351830JA).
- Profit-Building Techniques for Small Businesses (# 732411JA).
- Small Business Audits: Balancing Risk, Effectiveness and Efficiency in Today's World (# 732431JA).
- Successful Selling Strategies for CPA Firms, DVD/manual (# 181190JA), VHS/manual (# 181191JA), manual for DVD/VHS (# 351191JA).

JofA articles

- "Second-CPA-Firm Update," *JofA*, Sep.05, page 61, **www.aicpa.org/pubs/jofa/sep2005/dennis.htm**.
- "Small Firms: Think Big!" *JofA*, Jun.04, page 22, **www.aicpa.org/pubs/jofa/jun2004/dennis.htm**.

For PCPS members only

- "Not-for-Profit Board Member Orientation," a PowerPoint presentation for use with clients and prospects, educates board members on their roles and responsibilities and how they can manage and measure success (**http://pcps.aicpa.org/Resources/Not-for-Profit/Not-for-Profit+Board+Member+Orientation.htm**).
- The PCPS Firm Practice Center (**www.aicpa.org/pcps**) provides information for the PCPS membership section of 6,000 local and regional firms whose interests the AICPA represents to the profession, regulators and standard setters. PCPS offers CPAs practical guidance and quick access to information on professional issues affecting performance and profitability.
- *The TIC Alert* (**http://pcps.aicpa.org/Resources/Technical+Issues+Committee+and+Communications/Monthly+TIC+Alerts**) keeps PCPS members informed about new and developing standards and their potential impact on small business clients.

Publications

- *The CPA's Guide to Retirement Plans for Small Businesses* (# 017237JA).
- *The CPA's Guide to Small Business Financing* (# 091013JA).
- *How to Prevent, Deter and Detect Fraud in Your Business* (# 018200JA).
- *Not-for-Profit Organizations–AICPA Audit and Accounting Guide* (# 012645JA).

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Get the Word Out

Years of information can be conveniently stored at Web sites.

by Jeff Lenning

How do you distribute financial reports to clients, shareholders and key people in your organization? If you're low-tech, you probably mail them. If you've been following my suggestions of several years ago, you create hyperlinks in Excel files and e-mail the files so clients can drill down into them for details (see "Financial Reports in a Snap," *JofA*, Apr.00, page 31). But today's technology lets you do it a better way: uploading all clients' financial information to a Web site so they can access current and past reports 24/7, no matter how the data originally were formatted. If you want to learn how to do that, read on.

As you know, client data come in different formats. For example, tax software programs calculate and display returns with proprietary technology, and usually are able to convert themselves into the free Web-friendly Adobe Acrobat (files with a .pdf extension). Tax professionals usually prepare support data for schedule D basis computations in Excel, which isn't native to a Web browser, but it, too, can convert itself to hypertext markup language (HTML) so browsers can read it. P&L statements, which CPAs usually calculate and display with proprietary accounting software programs, also can translate themselves into Adobe Acrobat. Thus CPAs can easily store this virtual Tower of Babel of financial information, and clients can easily access it any time of the day or night via a Web site without any special technology.

A Web site also lets you extend Excel's presentation in a very powerful way. If you display a static worksheet, such as a balance sheet, and change only a single number on it, you have to replace the entire worksheet. But a special function in Excel transforms a static file being uploaded to a Web site into a dynamic, or interactive, file. Typical dynamic worksheets are loan-payment calculators and pivot tables, whose data adjust when their underlying information changes; there's no need to upload a whole new worksheet.

» Key to Instructions

To help readers follow the instructions in this article, we use two different typefaces: **Boldface** *type is used to identify the names of icons, agendas and URLs.* Sans serif *type shows the names of files and the names of commands and instructions that users should type into the computer.*

No Web Site? No Problem

If your organization doesn't have a Web site, you can use your local area network (LAN) to achieve the same goal—give quick and easy access to years of corporate data to those employees who are on a LAN. The techniques to store the data are almost identical. Security must be given high priority.

A Bank of Data

Now that we've described the flexibility and diversity of information that can be stored on the Web, let's see what such a site, also called a reporting portal, looks like. Exhibit 1, page 66, shows a screenshot of a typical opening page of a portal created by a CPA firm. As you can see, it contains three years of data—2003 to 2005—for client John Smith.

A click on any of the years' icons drills down to three further choices for that period: a .pdf copy of the client's 2004 final tax return, an HTML version of an Excel file on schedule D basis support and a .pdf version of final QuickBooks financial statements (exhibit 2, page 66).

If a client is applying for a mortgage, say, and needs a copy of last year's tax return and a current P&L statement, all he or she has to do is open the portal and click on a few icons for immediate access.

Convert an Excel File

To transform an Excel worksheet so it can be viewed by a browser, begin by opening

Exhibit 1

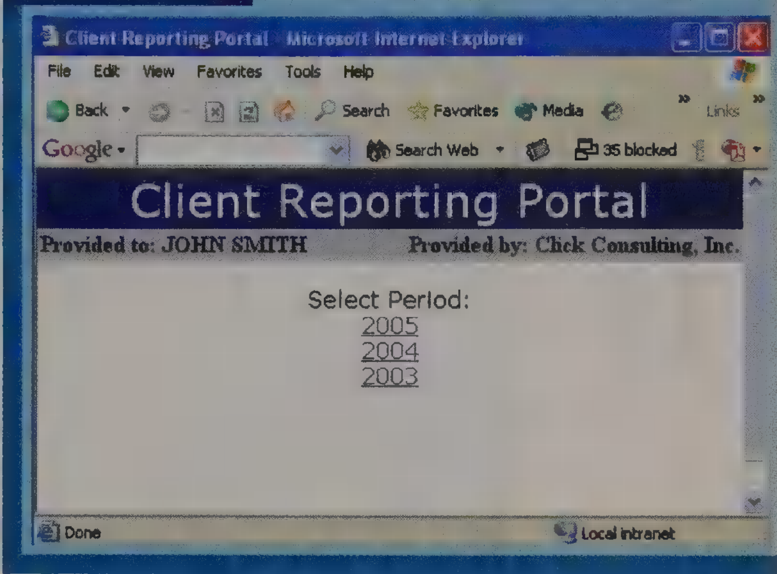


Exhibit 2

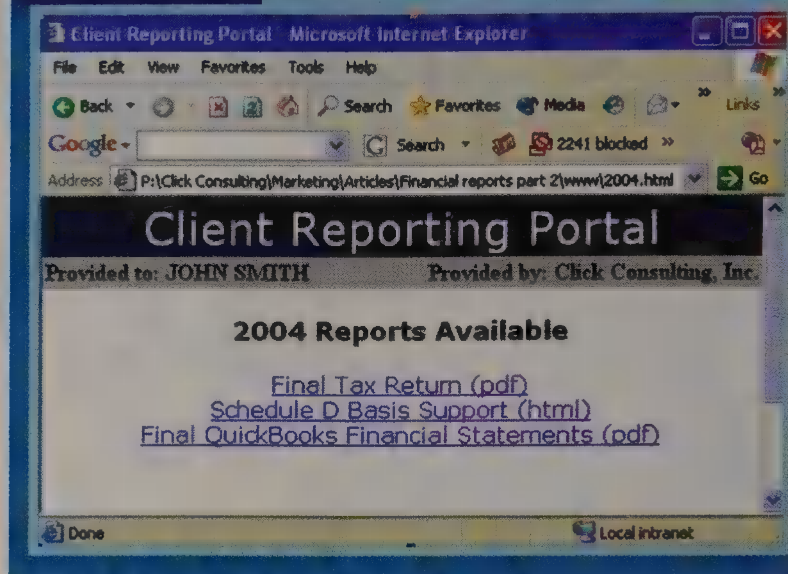
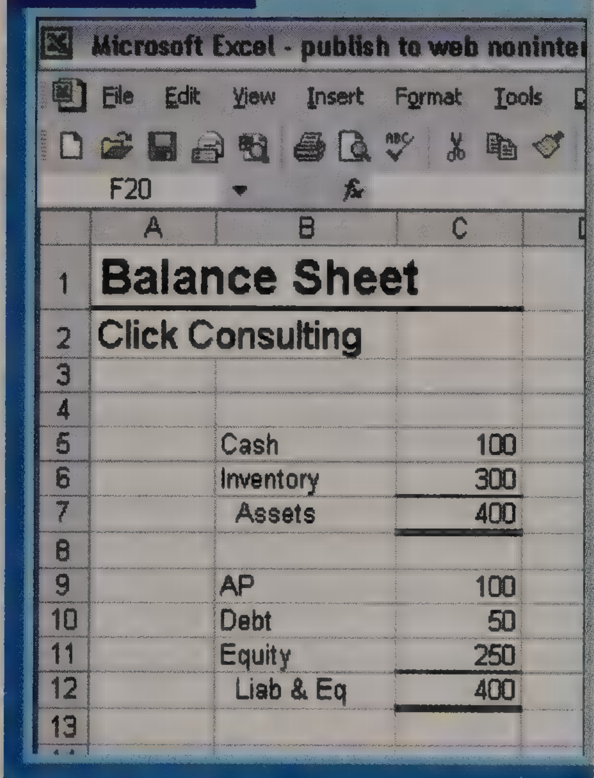


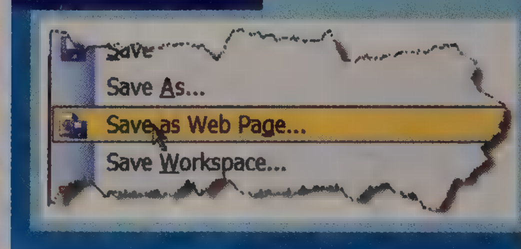
Exhibit 3



the target file, which has an .xls extension (see exhibit 3, at left).

Then click on **File**, **Save as Web Page** (exhibit 4, at right).

Exhibit 4



That launches the first screen of a **Save As** wizard (exhibit 5, page 67) that performs the actual conversion. In the **File name** box add a name; I used bsheet.htm. Be aware that the original Excel file (.xls) is left intact. You can select how much of the spreadsheet to include in the new bsheet.htm. You'll get the entire workbook if you place a check next to **Entire Workbook** or just the current worksheet if you check **Selection: Sheet**. Click on **Save**.

When the .htm page appears, it will be an exact visual duplicate of the original file right down to the formatting of the double underlines (exhibit 6, page 67).

Finally, to make the report available for viewing, upload bsheet.htm to your Web server.

INTERACTIVE DISPLAY

To prepare a dynamic display for the site, create an interactive file, such as a loan-payment worksheet (see exhibit 7, page 67), which uses Excel's **=pmt()** function in C6 to perform the dynamic calculations.

EXECUTIVE SUMMARY

■ **CPAs can use Web sites** to store many years of data, permitting clients quick and easy access 24/7. The sites, also called reporting portals, can handle data that are formatted in many different ways.

■ **Data that are otherwise** hard to display can be formatted without any special technology so they can be read by a Web browser.

■ **A special function** in Excel can transform a static file being uploaded to a Web site to a dynamic, or interactive, file. Typical dynamic worksheets are loan-payment calculators and pivot tables, whose data adjust when their underlying information change.

■ **Easy access to sensitive client data** comes with a price. You don't want such information to be easily accessible to everyone, so you must implement very effective security measures.

■ **If your organization's Internet site** does not have effective security, you have two choices: Hire a Web consultant with security experience or rent a professionally managed site and let its specialists set up a security system for you.

Jeff Lenning, CPA/CITP, is the founder of Click Consulting (**www.clickconsulting.com**)*, Seal Beach, Calif., which specializes in network support and application development. His e-mail address is jeff@clickconsulting.com.*

Then follow the same steps for a static file except place a check in the **Add interactivity** checkbox (see screenshot at right) in exhibit 5.

To specify additional options, click on the **Publish** button (see exhibit 5) to produce the dialog shown in exhibit 8, below.

Make sure you select **Spreadsheet functionality** from the **Add interactivity with** option. The other choices in that menu are **Pivot Table functionality**, which allows you to display pivot tables, and **AutoRepublish** option, which automatically uploads to the site any revisions you make in that workbook.

Click on **Publish** to close the wizard and the loan-payment workbook is ready for use.

Exhibit 5

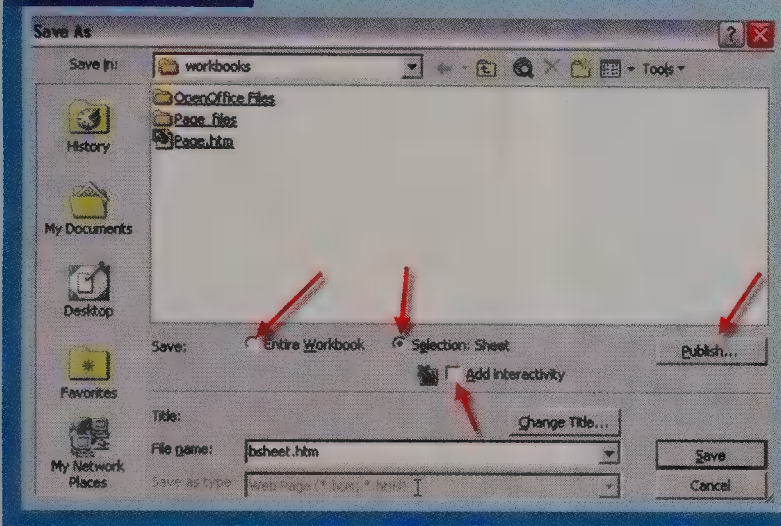
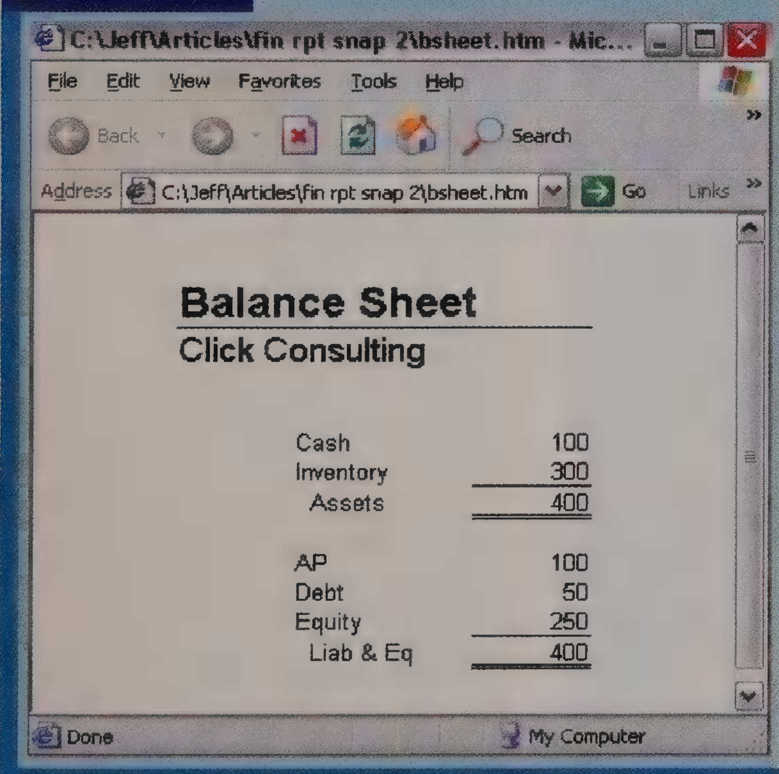


Exhibit 6



Alert: In order to use the dynamic worksheet you must access it with Microsoft's Internet Explorer browser; it will not work with Firefox or any other browser.

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The Security Issue

Easy access to sensitive client data comes with a price. After all, you don't want such information to be readily available to everyone. So you must implement very effective security measures to be sure only authorized users get at it.

If your organization's Internet site is of a do-it-yourself variety, it's not likely to have an effective security feature. That leaves you two choices: Engage a Web site consultant with security ex-

Exhibit 7

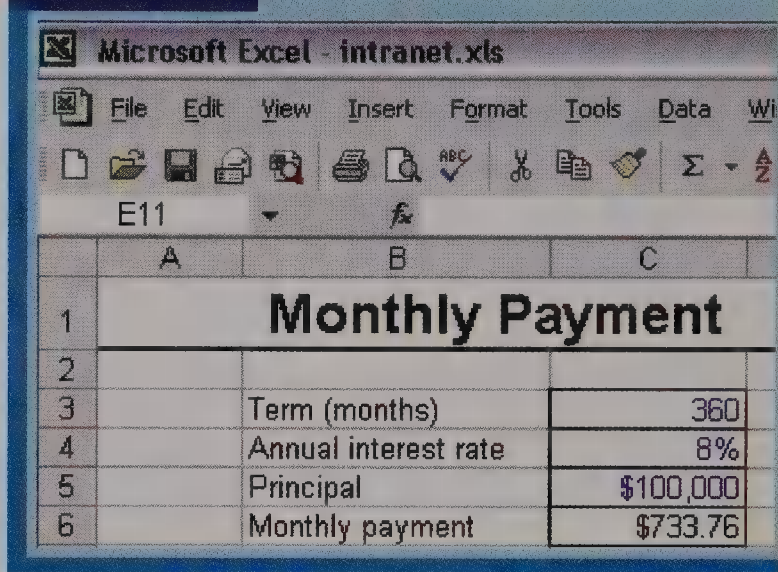
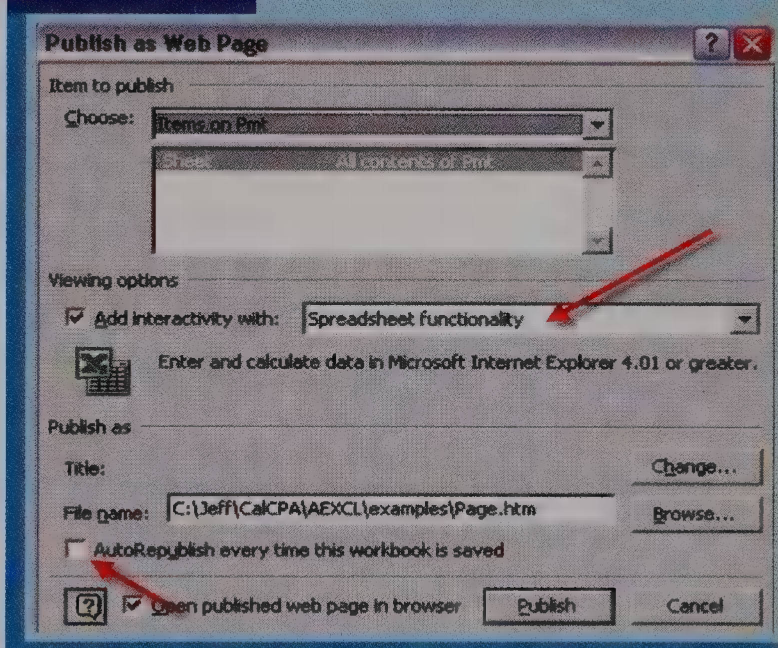


Exhibit 8



perience, or instead of using your own site, rent a professionally managed site and let its specialists set up a sophisticated security system for you. For a list of vendors that provide such services, see "Space for Rent," below.

As you can see, using a reporting portal provides you with a convenient place to store many years of data and allows your clients to view information, even if it's formatted in proprietary ways. ❖

Space for Rent

Vendors that rent Web sites:

■ **Accountants Office** (www.accountantsoffice.com) provides Web sites with CyberCabinet online file sharing. Prices start at $695 per year.

■ **CCH SiteBuilder's** (www.cch.com) software, ProSystem*fx* File Share, allows secure file sharing. The first 50 megabytes (Mb) of storage space are included with the basic subscription. Additional space is available in 100 Mb increments for about $100 a year. Free trial is available.

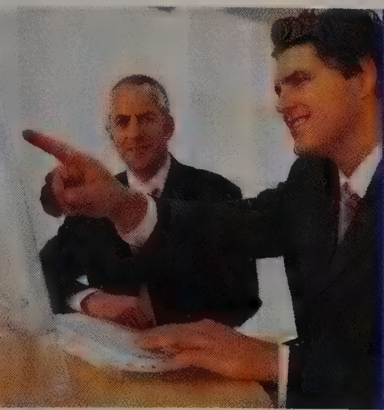
■ **CPA Site Solutions** (www.cpasitesolutions.com) offers Web site templates with a secure online file-exchange portal. Prices start at $50 per month.

■ **Creative Solutions Thomson** (www.creativesolutions.thomson.com) offers two products, Web Builder CS and NetClient CS, that provide clients with access to their financial reports through the Internet. Demos are available on its Web site. Prices start at $120 a month, with a one-time setup fee of $500.

■ **IKE** (www.ike.com) offers secure file sharing. A 15-day trial is available. Prices start at about $100 a year.

■ **Webex Weboffice** (www.weboffice.com) provides powerful collaboration services, including file sharing. A 30-day trial is available. Prices start at about $50 a month.

■ **XDrive** (www.xdrive.com) lets clients share files securely. Free trials are available. Prices start at about $100 a year.



JofA FOCUS REPORT

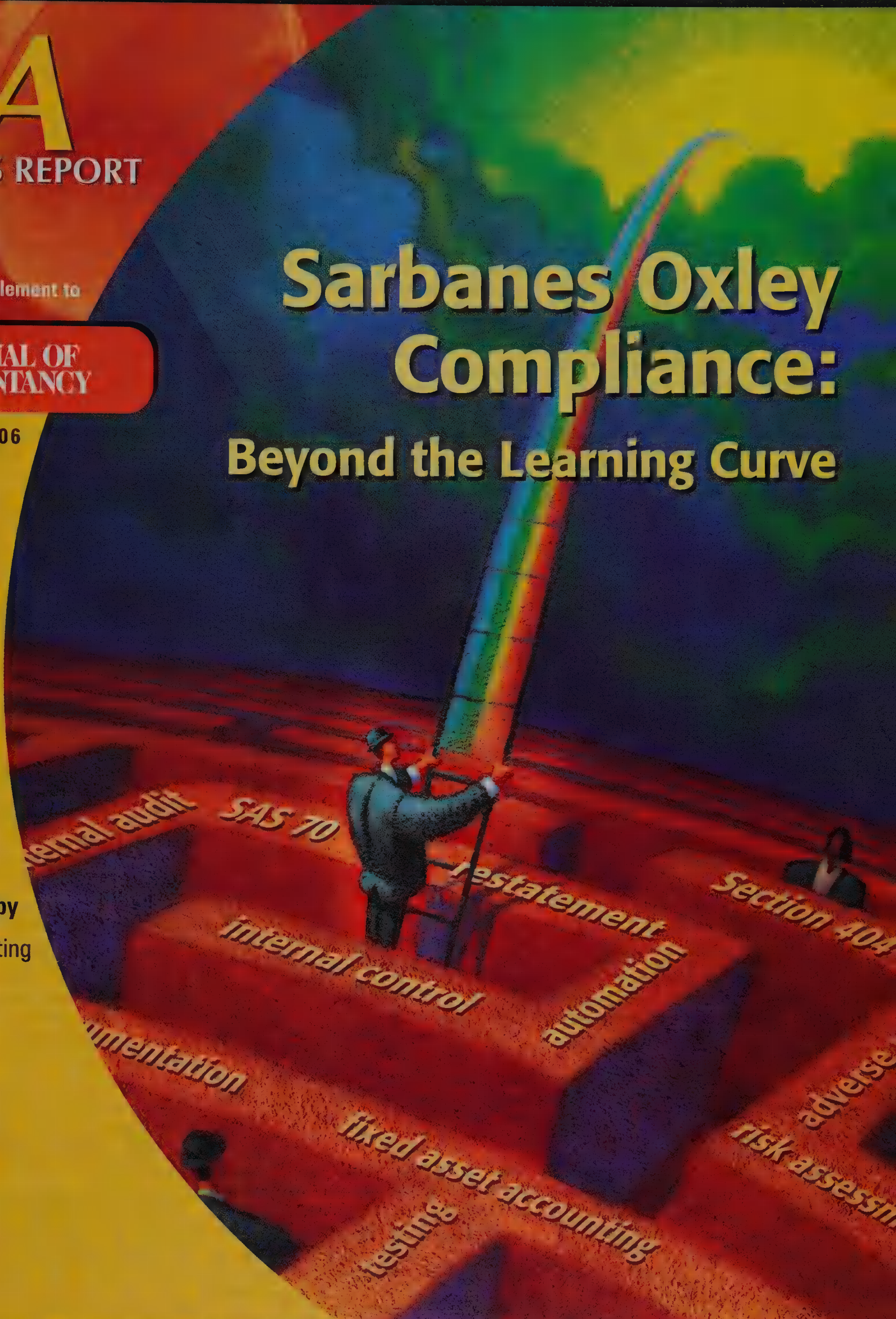
A special supplement to

JOURNAL OF ACCOUNTANCY

July 2006

Sarbanes Oxley Compliance:

Beyond the Learning Curve



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Executive Roundtable: Sarbox

Tim Leech
Paisley Consulting

David Copenhafer
Bowne & Company, Inc.

Rich Lanza
Audit Software Professionals

Mark S. Lilling
Lilling & Company, LLP

With the fourth anniversary of the passage of the landmark Sarbanes Oxley Act upon us, it's an opportune time to take stock of the progress that public companies and their boards and auditors have made, as well as the challenges that remain. As financial professionals and their organizations move up the compliance learning curve, the atmosphere of resistance, confusion and "catch-up" is being replaced by improved financial reporting systems, internal controls and transparency – but experts say more work needs to be done.

*To help CPAs better understand the latest Sarbox compliance trends, costs, benefits and emerging best practices, we've enlisted the help of **Tim Leech**, Chief Methodology Officer and Principal Consultant, Paisley Consulting; **David Copenhafer**, Director, EDGAR Services, Bowne & Company, Inc; **Rich Lanza**, CPA/CITP, President, Audit Software Professionals and **Mark S. Lilling**, CPA, Managing Partner, Lilling & Company, LLP.*

Panelists, what are the chief concerns or misconceptions that public company CPAs still have about complying with Sarbanes Oxley (Sarbox) regulations?

TIM LEECH (Paisley Consulting): The single biggest misconception we see is the belief that management must follow the same assessment approach mandated by the PCAOB in Auditing Standard No. 2. (PCAOB AS 2). As recently as May 17, the SEC announced plans to develop new guidance to alleviate this misconception and the PCAOB announced plans to revise AS2.

MARK LILLING (Lilling & Company): Many public company CPAs are only addressing the time costs and expenses associated with Sarbox. I hope they understand the advantages that strong internal controls bring to a company and subsequently to the public. Integrity in financial markets is worth the Sarbox cost.

When it comes to Sarbox compliance, how do smaller public companies differ from larger ones?

DAVID COPENHAFER (Bowne & Company): Smaller companies appear to be having greater difficulty gaining the time and attention of external auditors. The split between accelerated and non-accelerated issuers tends to focus auditor resources on the firms with the shorter SEC filing deadlines – the larger companies. As a consequence, many smaller firms end up being more rushed at the end of the cycle than larger firms, even though they have more time to prepare and file SEC periodic reports.

Lilling: Resources. Larger public companies have more resources and can obtain the expertise to analyze the issues and implement an action plan. Smaller companies have been delaying implementation while the effective dates for Section 404 are being pushed back. Smaller companies will benefit the sooner they implement Section 404.

Which accounting issues are the most troublesome for companies in the new Sarbox era?

Lilling: The Sarbox era is bringing new accounting issues to the forefront, especially variable interest entities, stock options and most recently, pension accounting. CPAs have to continue to step up and ensure that financial statements are fair and transparent and reflective of a company's true financial position, regardless of stock pricing and politics.

Leech: Our research indicates that companies are having the most difficulty in areas in which their external auditor had extensive involvement, up to and including, regularly booking accounting entries and correction entries during the year-end audit. This level of involvement resulted in the external auditor playing a key role in the control system of many companies in the areas of tax, mergers and acquisition accounting and complex accounting treatments.

Although Sarbox regulations are not yet mandatory for non public companies, which rules should private companies and not-for-profits consider adopting?

Lilling: The concept of strong internal controls, independent board members and audit committees overseeing the financial reporting process are key. Companies also should have conflict policies, confidential procedures for whistle blowers and adequate record retention.

RICH LANZA (Audit Software Professionals): The most valuable aspects of the regulations are those related to company anti-fraud procedures. They directly affect the bottom line by rooting out cash outflows relative to fraud. The AICPA has significant guidance in this area freely available at http://www.aicpa.org/antifraud/additional_info.asp.

Leech: Private companies should pay particular attention to the guidance related to anti-fraud assessment; to macro-level assessment of the controls over the financial statement close and disclosure process; and to macro-level assessment against a recognized control model.

What are the key ingredients to making Sarbox Section 404 sustainable?

Copenhafer: SEC guidance to public companies on Section 404 is essential. Continued rework of AS2 is also essential to making Section 404 a truly risk-based compliance process.

Leech: New and more practical, risk-based and modern assessment guidance for management. Also, a significant rewrite of PCAOB AS 2 to update the assessment methodology.

Lilling: Companies need to analyze and document their financial reporting models properly and produce reliable financial statements. Also, they need to understand the risks associated with a business and follow guidance in the Treadway Commission's report to minimize these risks.

Is it possible to integrate processes such as risk management, audit management and financial data analysis?

Lanza: Most companies are still working down the path of automating their documentation or data analysis. This will change over time as companies' risk management databases become more standardized and the Sarbox process becomes part of the fabric of the organization.

Lilling: Many companies use software as a tool to document their Sarbox compliance, but software is only a tool. Companies must spend the qualitative time to understand their businesses, their systems and how adequate controls can be established and monitored.

What kinds of companies are most likely to be filing adverse 404 reports?

Leech: It's more common in small to medium enterprises, although more than a few large companies have numerous external audit mandated adjustments each year.

Lilling: Agreed. Companies of all sizes have filed adverse reports, however most are from smaller companies in the early filing stage.

Lanza: Companies with less than $1 billion in annual revenue were 50% more likely than those above the $1 billion mark to have received adverse opinions among all first-year section 404 disclosures tracked by AuditAnalytics.com. The entertainment, restaurant, mining and telecommunications industries were most frequently cited in Year One -- all of which exceeded a 30% failure rate. By contrast, real estate, hotels and motels, pharmaceuticals, biotechnology and utilities, each had failure rates below 10%.

What key resources do public companies need to comply fully with Sarbox regulations?

Copenhafer: People, cash, technology and more. Achieving compliance requires restructuring any number of internal and external procedures and workflow arrangements. Communication and coordination between and among board members, members of the audit committee, corporate finance and accounting, other officers and directors, all need to be examined and possibly re-engineered to meet Sarbox objectives.

Leech: In the first three years of SOX, companies have under-invested in staff training and technology to support cost-effective compliance and they've over-invested in outside consultants.

Lanza: Now that the compliance process is better defined, companies are starting to implement technology more fully to manage the workflow, perform automated testing and conduct external benchmarking to other registrants in their industry.

"The Sarbox era is bringing new accounting issues to the forefront, especially variable interest entities, stock options and most recently, pension accounting"

To what extent has the Sarbanes Oxley Act improved companies' internal control processes and which areas are still most in need of improvement?

Lilling: Sarbox has improved processing transactions, sales, purchasing and inventory. Consistency in recording of accounting estimates, accruals and reserves still could be a lot better.

Leech: The two areas most needing improvement are (a) excessive focus on processes that have rarely produced unreliable disclosures and (b) inadequate attention paid when analyzing the critical controls related to anti-fraud, the financial close process and the effectiveness of audit committees.

What are the key qualities to look for in a high-performing internal auditor? Does being a CPA help?

Leech: A key quality is having invested the time and resources to be fully conversant with all SEC and PCAOB guidance. This allows him or her to have 'fact-based' debates with their company's external auditor over how to meet SOX requirements cost-effectively.

Lilling: Look for intelligence, independence, education, leadership, ability to understand projects and achieve results. Being a CPA indicates that the auditor has achieved a certain level of education, expertise and ability.

If you could revise the Sarbanes-Oxley Act, what changes would you make?

Leech: External auditors should be required to audit and report on the reliability of the control assessment done by management. External auditors should not be asked if they personally think controls are adequate or effective.

Lilling: Revise, don't amend, Section 404 to be more realistic for smaller public companies. I'd like to see a cost-benefit analysis enabling smaller companies to develop better controls, without spending more than the benefits received.

How does complying with Sarbox regulations benefit companies and their shareholders the most?

Copenhafer: Market acceptance and shareholder value are entirely dependent on regulatory compliance. As with many aspects of most businesses, failure is not an option.

Lilling: The greatest value is for shareholders to see that top management has integrity and high ethical values and understands the importance of producing accurate financial statements with adequate disclosure to the public. ■

Edited by Hank Berkowitz and Sukanya Mitra. Designed by Lisa DeBellis.

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A Better Way to Evaluate IT Controls

By Martin J. Coe

Excerpted from *Journal of Accountancy*, March 2005.

Section 404 of the Sarbanes Oxley Act requires public companies to include in their annual reports an assessment by management of their internal controls over financial reporting. This includes a statement of management's responsibility for establishing and maintaining adequate internal control, an assessment of the effectiveness of those controls as of the end of the most recent fiscal year, a statement identifying the framework that was used to evaluate those controls and a statement that the external auditor issued an attestation report on management's internal control assessment.

The final SEC rules say management must base its internal control evaluation on a suitable, recognized control framework established by a body or group that followed due process procedures. The rules say a suitable one must be free of bias; permit reasonably consistent qualitative and quantitative measurements; include all relevant factors that might alter a conclusion about the effectiveness of the internal controls; and be relevant to an evaluation of internal control over financial reporting.

Three Options

COSO (www.coso.org). The framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) satisfies the SEC criteria. It is used to meet management's annual internal control evaluation and disclosure requirements. Its framework defines internal control, describes its components and provides criteria against which CPAs can evaluate control systems.

COBIT (www.isaca.org). The Information Systems Audit and Control Foundation developed the control objectives for information and related technology (COBIT). This is a generally applicable and accepted standard for IT security and control practices that provides a reference framework for management, users, auditors and security practitioners.

Trust Services (www.aicpa.org/trustservices). The foundation of the AICPA/CICA Trust Services framework is a set of principles and criteria CPAs can use to assess the reliability of a company's IT systems. The criteria constitute professional guidance and serve as best practices for system reliability.

Information Technology Controls

Because companies rely heavily on technology, the criteria they use to assess the effectiveness of their IT-related controls are particularly important. While COSO addresses the topic of IT general controls, it does not dictate requirements for control objectives and related activities. Thus, to meet the requirements of Section 404, IT management and auditors need a specific IT control framework.

One reason companies use the COBIT framework for Sarbanes-Oxley compliance is that its objectives have been mapped to COSO in *IT Control Objectives for Sarbanes-Oxley* (available at www.isaca.org). COBIT also has been mapped to popular enterprise resource planning (ERP) systems such as SAP, Oracle and PeopleSoft. This mapping and related guidance provides COBIT framework references and methodologies for auditing and testing the major ERP systems.

While COBIT is an excellent comprehensive framework for assessing IT controls, many clients are using a narrower framework that complements the overall COSO model. Trust Services focuses on the controls that are in place to ensure the company's systems carry out business processes reliably.

Applying the Framework

The AICPA and CICA developed the following Trust Services principles and related criteria for CPAs to perform consulting engagements and branded attestation engagements, e.g. SysTrust and WebTrust.

- ***Security.*** Protects against unauthorized access, both physical and logical.
- ***Availability.*** Available for operation and use as committed to or agreed upon.
- ***Processing integrity.*** Processing is complete, accurate, timely and authorized.
- ***Confidentiality.*** Confidential information is protected as committed to or agreed.
- ***Privacy.*** Personal information is collected, used, retained and disclosed in conformity with the commitments the entity makes in its privacy notice and with the AICPA/CICA Trust Services privacy criteria.

Trust Services' illustrative controls allow management to identify both missing and existing controls for all criteria/objectives (see sidebar).

CPAs can use the detailed control matrices that contain a row for each of the Trust Services criteria to form questions that will determine whether key controls are in place. The framework is based on the premise that if system controls operate effectively, the system itself will perform reliably.

These steps allow the COSO framework to defer to the Trust Services framework for a more detailed evaluation to determine whether the IT systems a company uses to support and create the financial reports are reliable.

Meeting the Challenge

Fulfilling the IT control aspects of the internal control assessment that Sarbanes-Oxley requires can be a challenge for CPAs. While each company will need to decide the framework most appropriate for its needs, Trust Services is a useful option that CPAs will find particularly helpful when the overall framework they use does not pay sufficient attention to IT issues. ■

Martin J. Coe (MJ-Coe@wiu.edu), CPA/CISA, is an assistant professor of accountancy at Western Illinois University, Moline, and a practicing information technology auditor.

Sample Trust Services Security Principle Illustrative Controls

Procedures exist to protect against unauthorized logical access to the defined system.

1. Log-in sessions are terminated after three unsuccessful log-in attempts. Terminated log-in sessions are logged for follow-up by the security administrator.
2. Virtual private networking (VPN) software permits remote access by authorized users. Users are authenticated by the VPN server through specific client software and user IDs and passwords.
3. Firewalls are used and configured to prevent unauthorized access. Firewall events are logged and reviewed daily by the security administrator.
4. Unneeded network services (e.g. telnet, ftp) are deactivated on the entity's servers. A listing of the required and authorized services is maintained by IT. This is reviewed by entity management on routinely for its appropriateness for the current operating conditions.
5. Intrusion detection systems are used to provide continuous monitoring of the network and early identification of potential security breaches.
6. The entity contracts with third parties to conduct periodic security reviews and vulnerability assessments. Results and recommendations for improvement are reported to management.

Source: AICPA/CICA Trust Services principles and criteria.

Selecting SOX Software

By Richard B. Lanza, CPA/CITP

Technology can be a great help in managing he onslaught of work required to document, report on and audit internal controls. But with vendors slapping the "Sarbanes-Oxley Software" bumper sticker on almost every technology product these days, it's easy to become confused (see sidebar).

Against this backdrop, here are three considerations to keep in mind when automating your Sarbanes-Oxley compliance efforts:

Consideration #1 — The Power of the Database

The database's raison d'être is to turn a slew of spreadsheets, word processing documents, flowcharts and e-mails into a concise package of internal control documentation. Most companies are documenting their internal controls using Excel spreadsheets, which are easy to implement. However, while Excel may be a comfortable option for the CPA, Excel spreadsheets are not very secure and can get out of control quickly. "We can't tell you how many clients are finding after their year-one Sarbanes-Oxley exercise that they simply can't repeat the same documentation effort in year two," says Bill Douglas from Cost Advisors, Inc., who supports SarbOxPro, a risk management database application. "They need a database and are actively searching to get away from the Excel madness."

The benfits of a database include:

- Consistency — A database is ideal for organizing information in a consistent manner. Consistency speeds the review process, as auditors know intuitively where to look for their desired data.
- Quick Searching Speed?— Once stored in a database, the information is better organized for future action, and also provides a sound foundation for reporting the collective risk management data. This is a near impossibility when data is stored in various spreadsheets.
- Security — Role-based security allows users to access only what they need. Some will need access to the entire database, while others will only need access to their specific task within the company.

> "Most companies are documenting their internal controls using Excel spreadsheets...[although] they are not very secure and can get out of control quickly."

Consideration #2 — Make It Easier For Your Auditors...and Yourself

At the end of the day, auditors need to evaluate the organization's internal controls. When these are documented in a comprehensive yet consistent database, auditors can more easily complete internal control reviews—and fees can remain in check. For example, auditors can readily analyze segregation of duties around cash processing in a database query as opposed to searching through numerous process memos.

While most of the discussion in internal-control technology surrounds documentation, testing of controls also can be automated. Automating the mind-numbing testing of controls allows companies to devote their time to investigating identified control exceptions and creating value for their organizations. For systems where automated control tests make sense, the first step is simply to turn on "system audit logs." These logs, which are normally turned off, can add new perspectives on how systems are being used at a minimal cost. Once enabled, they provide a wealth of data for automated testing, which is generally much faster than a manual sample.

Consideration #3 — Test for Management Override and Find Fraud in the Data

Regardless of how strong an internal control system is, it still can be circumvented by upper management—usually by issuing false top-side journal entries.The Worldcom fraud, for example, was detected by internal auditors through a relatively simple journal entry trend analysis. With this in mind, companies can support their Sarbanes-Oxley testing and set an Anti-Fraud Program and Control by issuing standard general ledger reports on a monthly basis.

> "Automating testing of controls allow companies to devote time to investigate identified control exceptions and create value for their organizations."

Companies also can focus fraud-specific data analysis testing on a host of areas, most notably in the revenue and inventory cycles. As accounting information becomes more digitized and the software tools become cheaper to obtain (with many residing in Microsoft Excel), companies are in a perfect position to improve their data analysis capabilities in the fight against financial statement fraud. ■

Rich Lanza (rich@auditsoftware.net), CPA/CITP, president of Audit Software Professionals, has 15 years of experience in audit and assurance technology.

SARBANES-OXLEY REQUIRES THAT MANAGEMENT include an assessment of internal controls over financial reporting, using a suitable framework, in the annual report. While a number of frameworks are available, some do not adequately assess technology controls.

SEC RULES SAY MANAGEMENT MUST BASE its evaluation of the effectiveness of internal controls over financial reporting on a recognized control framework issued by a group that followed due-process procedures. The framework must be free from bias, complete and relevant to the task at hand, and must permit consistent quantitative and qualitative measurements.

SEVERAL GROUPS, INCLUDING COSO, COBIT and AICPA/CICA Trust Services, have issued frameworks CPAs can use to evaluate internal controls, particularly controls over a system's IT aspects. In a survey of CEOs and CFOs, 28.4% said they used a model other than COSO to assess the effectiveness of their IT internal control structure.

TAX MATTERS

TAX CASE

REFINING THE DEFINITION OF A CAPITAL ASSET

Section 1221 of the tax code broadly defines a capital asset. Over time the courts have attempted to narrow that definition and eliminate confusion. Recently a Third Circuit Court of Appeals ruling brought further clarification.

In June 1991 George and Angeline Lattera purchased a Pennsylvania lottery ticket for $1 and won $9,595,326. In September 1999 they received court approval to sell the rights to the remaining 17 annual payments of $369,051 for $3,372,342. They reported this transaction as a long-term capital gain. The IRS reclassified it as ordinary income and assessed a $660,784 deficiency. The taxpayers petitioned the Tax Court to eliminate the deficiency; the court sided with the IRS. The couple then appealed to the Third Circuit.

Result. For the IRS. Both the Tax Court and the Ninth Circuit Court of Appeals have ruled that the sale of lottery winnings generates ordinary income. Because of the harsh criticism of these decisions, the Third Circuit reexamined the issue to clarify what property qualifies as a capital asset.

In *Hort* and *Lake*, the Supreme Court narrowed the definition of capital asset by establishing the "substitute for ordinary income" exception. Under this exception, the sale of property that generates a receipt which is a substitute for future ordinary income is not a sale of a capital asset. It has been suggested that the Supreme Court's 1988 decision in *Arkansas Best* rejected this exception. Although most courts do not fully discuss the exemption's limits or reconcile differences in prior decisions, they find that the exception survived the *Arkansas Best* holding.

In the current case, the Third Circuit provided an analytical framework for addressing this issue. According to the appeals court, certain assets (stocks, bonds and options) are clearly capital and others (interest and rent) are unmistakably ordinary income. When disputes arise, a court should consider the nature of the property. If the property more closely resembles a capital asset, it is capital; if it more closely resembles ordinary income property, it is ordinary income.

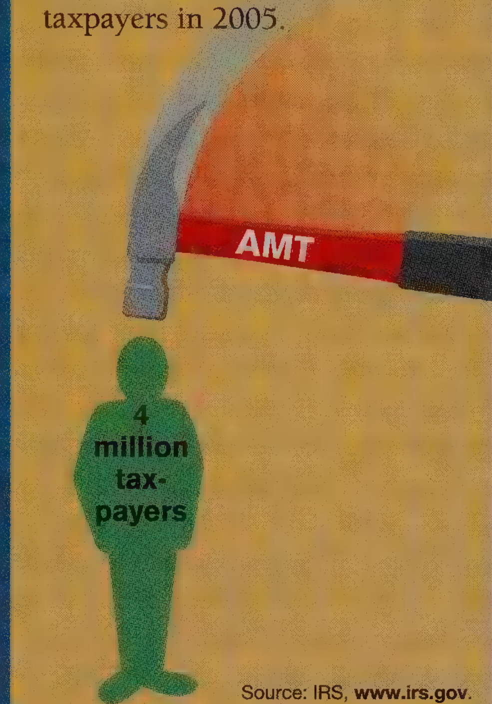
If the property does not closely resemble either extreme, then the court should determine whether the transaction created a horizontal or a vertical carve-out. A horizontal carve-out, which disposes of only part of the taxpayer's interest in the property, generates ordinary income. In a vertical carve-out, which disposes of all of the taxpayer's remaining rights in the property, the court must determine whether the taxpayer disposed of a right to future income that had previously been earned—which generates ordinary income—or a right to earn future income—which creates capital gains.

A winning lottery ticket does not closely resemble either capital or ordinary income. Therefore, the court examined the type of carve-out the transaction created. The taxpayers sold all the remaining installments of their winnings; thus, they created a vertical carve-out. Since the purchaser receives the installments automatically, the taxpayers sold a right to future income. When they sold the remaining installments, the taxpayers received ordinary income.

The Third Circuit's approach, which is new, attempts to reconcile all of the major cases. If other courts adopt this approach,

AMT=A Mean Tax

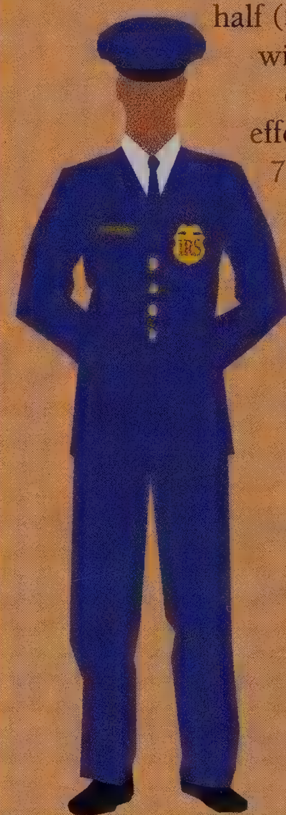
Households subject to the alternative minimum tax (AMT) pay an average of $2,770 more in taxes than other taxpayers. The AMT snagged 4 million taxpayers in 2005.



Source: IRS, www.irs.gov.

Uncle Sam Means Business

Of the $10.7 billion in the 2006 IRS budget, almost half ($4.7 billion) will go toward enforcement efforts. That's a 7.8% increase over 2005.



Source: IRS, www.irs.gov.

taxpayers will need to change their analysis of disputed property and present different arguments to support their capital asset treatment.

■ *George Lattera v. Commissioner*, 437 F3d 399 (CA-3).

Prepared by Edward J. Schnee, CPA, PhD, *Hugh Culverhouse Professor of Accounting and director, MTA program, Culverhouse School of Accountancy, University of Alabama, Tuscaloosa.*

TAX CASE

CO-OP REAL ESTATE TAXES NOT DEDUCTIBLE FOR AMT

Taxpayers generally can deduct expenditures they incur directly, but not expenditures paid by others on their behalf. IRC section 216, however, allows tenant-stockholders to deduct a proportionate share of real estate taxes paid by a cooperative housing corporation (co-op). *Ostrow v. Commissioner* addressed the deductibility of these taxes when computing a tenant-shareholder's alternative minimum tax (AMT) liability.

The Ostrows, who were subject to AMT, deducted real estate taxes paid by the co-op on their joint return; the IRS disallowed the deduction. The couple argued that since the section 216 deduction had not been specifically disallowed, it was permitted in computing the AMT. The Tax Court disagreed, saying a tenant-shareholder's share of the co-op's real estate taxes was not deductible for purposes of determining the AMT. The taxpayers appealed to the Second Circuit Court of Appeals.

Result. For the IRS. IRC section 164(a)(1) allows taxpayers to deduct real property taxes paid or accrued during the taxable year. In the case of a co-op, this section permits the corporation to deduct real estate taxes it pays relating to the houses or apartment building it owns. IRC section 216 expands section 164 to reach tenant-stockholders of co-ops. Specifically, section 216(a)(1) allows a tenant-stockholder to deduct his or her proportionate share of the real estate taxes the co-op can deduct under section 164.

Taxpayers are required to pay a minimum amount of taxes, referred to as the AMT, pursuant to IRC section 55. Some deductions allowed for regular tax purposes are disallowed in the computation of AMT; one such item is taxes. IRC section 56(b)(1)(A)(ii) disallows the deduction for any "taxes described in" section 164(a). However, section 56 does not specifically provide that a deduction allowed under section 216 is disallowed in computing a taxpayer's AMT.

The issue before the court—one not previously heard by the Second Circuit or any other court of appeals—was whether the deduction for real property taxes permitted by section 216 had been disallowed for AMT purposes. The taxpayers argued that since the adjustments for AMT had not expressly included section 216, the deduction was permitted. They cited other IRC provisions that list sections 164 and 216 separately to prove that Congress had specifically included section 216 when it intended for another provision to apply to it.

The IRS argued that the section 216 deduction was disallowed for AMT purposes because it related to a tax described in section 164(a). It also said the language of section 56 did not disallow deductions for real property taxes provided by a particular section. Rather, the IRS argued, the phrase "taxes described in" caused *all* real property taxes to be disallowed, regardless of which section permitted the deduction for regular tax purposes. Section 164 allows a deduction for state and local real property taxes, and section 216 explicitly incorporates section 164. The only distinction is that the section 216 taxes are paid by the co-op rather than directly by the taxpayer. Thus, because the section 216 deduction in this case related to a tax described in section 164(a), it was disallowed for AMT purposes.

The Second Circuit agreed with the IRS and affirmed the Tax Court's decision. In disallowing the deduction, the court reviewed the history of section 216. Prior to 1942, the courts had held that tenant-stockholders could not take deductions for taxes paid by a co-op. However, in an effort to treat them the same as homeowners, Congress added a provision to the tax code specifically allowing tenant-shareholders to deduct such taxes. The Senate Finance Committee report said the purpose of the new deduction was "to place the tenant stockholders of a cooperative apartment in the same position as the owner of

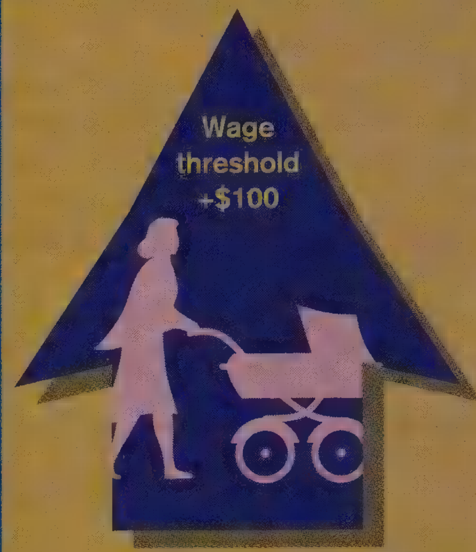
What an Upper!

The IRS increased the personal exemption amount by $100, to $3,300, for tax year 2006.

Source: IRS, **www.irs.gov.**

Good News for Employers

The IRS hiked the nanny tax wage threshold by $100, to $1,500 for 2006. Employers who pay household help more than this amount must pay Social Security and Medicare taxes.



Source: IRS, **www.irs.gov.**

CHARTS BY KELLEY GRAPHICS

a dwelling house so far as deductions for interest and taxes are concerned." Accordingly, Congress intended for taxpayers to deduct real estate taxes whether they paid the taxes directly or indirectly through a co-op. However, taxpayers who pay real estate taxes indirectly should not receive benefits denied to those who pay taxes directly. Allowing tenant-shareholders to deduct real estate taxes for AMT purposes would do just that and is not consistent with the stated purpose of section 216. Consequently, no taxpayer can deduct real estate taxes for AMT purposes—whether the taxes are paid directly or indirectly.

■ *Ostrow* v. *Commissioner*, Docket no. 05-0261, CA-2.

Prepared by Laura Lee Mannino, CPA, LLM, *assistant professor of accounting and taxation, St. John's University, Jamaica, New York.*

TAX CASE

WHEN IS A LIABILITY A LIABILITY?

To deduct an accrued expense, an accrual-basis taxpayer must satisfy an all-events test. The test has two prongs: Does the liability exist and, if so, can it be measured with reasonable accuracy? Legally a liability exists when it is final, fixed and absolute; that is, when the last event creating it has occurred and economic performance has occurred.

During 1984 and 1985, Chrysler Corp. sold vehicles covered under a company warranty as well as by the Uniform Commercial Code and the Magnuson-Moss Act. On its 1984 and 1985 tax returns, Chrysler deducted the estimated amount of possible future warranty claims related to vehicles sold in those years. The IRS disallowed the deductions and assessed the company a deficiency. Chrysler petitioned the Tax Court for relief, arguing that due to the warranty statutes the sale of the vehicles to its dealers was the last event that "fixed" its liability.

Chrysler cited *United States* v. *Hughes Properties, Inc.*, 473 US 593, where a casino accrued a deduction for future slot machine payouts when a state law required the casino to pay out a set percentage of the amounts put into the machines. The Supreme Court held that the last event that created the casino's liability was the placing of the last coin into the slot machines at the end of the year. Chrysler argued that in this case any statutory liability fixed the liability and thus satisfied the first prong of the all-events test.

The government cited *United States* v. *General Dynamics Corp.*, 481 US 239, in which the Supreme Court disallowed a deduction for the estimated costs of employee medical expenses under a medical reimbursement plan. In that case the last event fixing General Dynamic's liability was when the employees filed proper claims with the company—*not* when the employees received medical care. Agreeing with the IRS, the Tax Court found that Chrysler's situation was similar to the General Dynamics case. The company appealed the case to the Sixth Circuit Court of Appeals.

Result. For the IRS. Both parties cited the same cases. The Sixth Circuit examined what a taxpayer must do in order to "establish liability with sufficient certainty." It held that although a statute imposing an obligation *may* be sufficient to establish an absolute liability, it is not necessarily sufficient. The court also held that Chrysler's warranty liability was contingent; to fix a liability a customer actually had to submit a warranty claim. Furthermore, a taxpayer may not deduct estimated expenses even though they are statistically certain.

This case illustrates the difference between the recognition of a liability and the related deduction for tax purposes on the one hand and the recognition of a liability and the related expense under generally accepted accounting principles (GAAP) on the other. GAAP requires only the existence of a present obligation resulting in the probable transfer of assets or the providing of services in the future as a result of a past transaction or event.

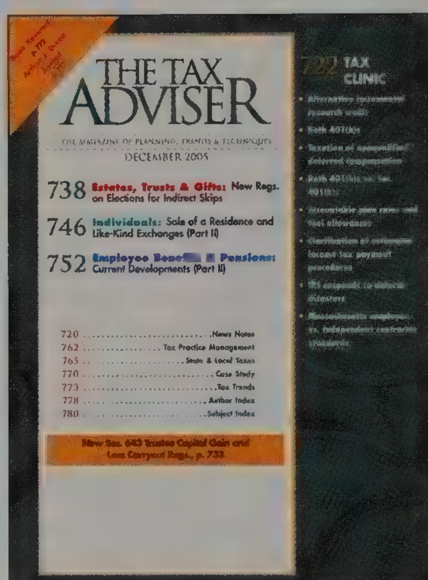
■ *Chrysler Corporation* v. *Commissioner*, 436 F3d 644 (CA-6).

Prepared by Charles J. Reichert, CPA, *professor of accounting, University of Wisconsin, Superior.* ❖

PAY SPECIAL ATTENTION IN AN ELECTION YEAR

Lobbying and Political Activities of Public Charities

Under normal circumstances, charities must be careful how they deal with political issues, to ensure they do not engage in prohibited political activity. During an election year, they must be especially careful. Failure to monitor a charity's activities or those of its members may trigger IRS sanctions, which can range from imposition of excise taxes to revocation of the organization's tax-exempt status. The rules for political and lobbying activities by public charities vary, depending on the type, scope and amount of activity conducted.



LOBBYING

Lobbying activity includes attempts to influence legislation at any level of government; legislation does not, however, include actions by executive, judicial or administrative bodies. An organization attempts to influence legislation by contacting, or urging the public to contact, members or employees of a legislative body for the purposes of proposing, supporting or opposing legislation, or by advocating the adoption or rejection of legislation.

Public charities may engage in lobbying as long as it does not constitute a "substantial part" of their total activities; the IRS will consider both the quantity and the quality of a charity's actions. Certain exempt organizations (other than churches and private foundations) may elect to apply an expenditures test; a charity will not jeopardize its exempt status as long as its lobbying expenditures do not exceed certain limits. Charities that go over these limits in any one year are subject to a 25% excise tax on the excess expenditures.

Some activities allowed. Exempt organizations may be involved in some activities that deal with public policy issues. These include conducting (on a nonpartisan basis) educational meetings or preparing and distributing educational materials.

POLITICAL ACTIVITY

Political activities by charitable organizations are absolutely prohibited. Exempt organizations may not directly or indirectly participate in any political campaign on behalf of, or in opposition to, any candidate for public office. This prohibition applies to campaigns at all levels of government. Even saying that a charity does not care who is elected, as long as one candidate is not, is unacceptable.

Candidates may be asked to speak at charitable events about their personal experiences in their capacity as individuals (for example, because they are celebrities, military leaders or experts in a nonpolitical field). If they intend to speak on issues regarding a current political campaign, however, the charity must (1) provide an equal opportunity to other candidates seeking the same office, (2) not indicate any support or opposition to any candidate and state that explicitly in the introductions and (3) not engage in political fundraising.

Charitable organizations can engage in "issue advocacy" by taking a position on issues, but must avoid issue advocacy that functions as political campaign intervention. This usually hinges on whether the organization expressly or implicitly encourages voters to vote for or against a specific candidate.

Note that there is no bright-line test to determine whether a charity is involved in prohibited political campaign intervention. A charity might engage in several different activities, none of which would be considered political activity on its own. When viewed together, however, the activities may indicate that the organization has engaged in political activity.

For more information, see Tax Clinic, "Election-Year Focus on Lobbying and Political Activities of Public Charities" by Gretchen Kurhajetz, CPA, in the July 2006 issue of *The Tax Adviser.*

—*Nick Fiore*
The Tax Adviser

Notice to Readers:

Members of the AICPA tax section may subscribe to *The Tax Adviser* at a reduced price. Contact Judy Smith at 202-434-9270 for a subscription to the magazine or to become a member of the tax section.

Technology Q&A

by Stanley Zarowin

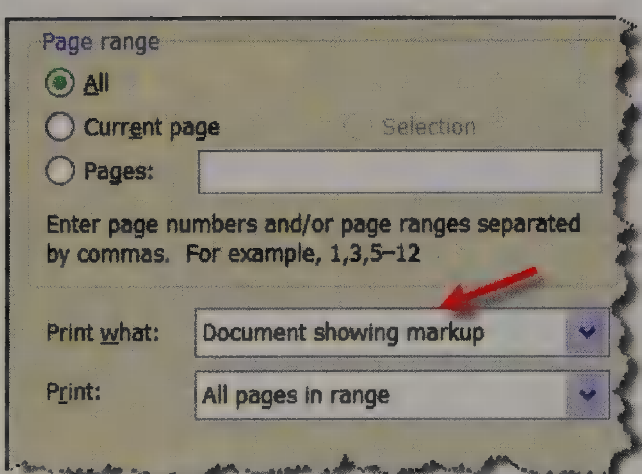
Print with or without Track Changes comments...A fast way to replace two spaces after the period with one...Search multiple worksheets...Outlook has a "You've Got Mail" option...A better way to stamp...A good idea...Another better way

> **»Key to Instructions**
>
> *To help readers follow the instructions in this article, we use two different typefaces:*
>
> **Boldface** *type is used to identify the names of icons, agendas and URLs.*
>
> Sans serif *type shows the names of files and the names of commands and instructions that users should type into the computer.*

PRINT WITH OR WITHOUT TRACK CHANGES COMMENTS

Q Unlike some of your readers, I like Word's **Track Changes** feature because it provides an easy way to edit and add comments to a document. However, I am having trouble printing documents with comments. How do I get the choice of whether to print with or without comments?

A When you're ready to print, either click on **File, Print** or use the Ctrl+P shortcut to evoke the **Print** screen. If your document contains comments and/or edits, the default **Print what** command *usually* is **Document showing markup**, which means it will print with comments. I say *usually* because Microsoft Office being what it is, the default command is sometimes unpredictable, so just be careful what you select from the drop-down menu.



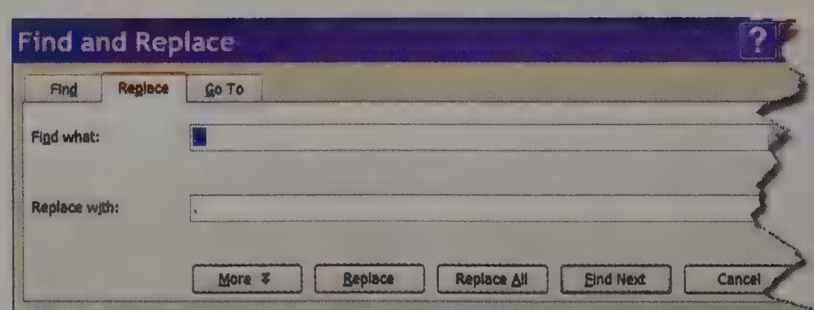
In general, if the document was prepared without **Track Changes** or they already have been cleared, the usual default is **Document**.

A FAST WAY TO REPLACE TWO SPACES AFTER THE PERIOD WITH ONE

Q As the officer manager of a midsize firm, I review all documents created by the accountants for spelling, grammar and style. No matter how often I tell them that the period at the end of a sentence is followed by one space—not two—I get memos with mostly two spaces. The writers tell me they learned to use two spaces in school and it's a typing habit they can't break. You're in the editing business, what do you suggest?

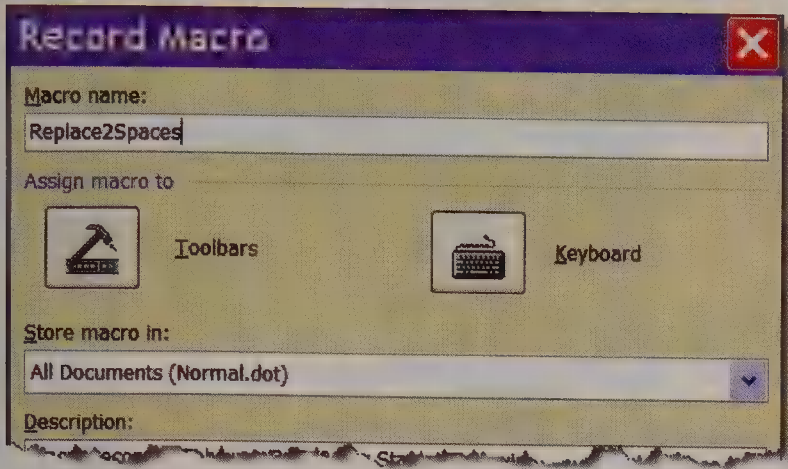
A I suggest you accept reality and add a macro to your computer that corrects every sentence end to one space with the click of a mouse.

To create the macro, click on **Tools, Macro** to open the **Record New Macro** wizard. Give the macro a name (remember, it must be one word)—such as Replace2Spaces—and click on **OK**. While the macro recorder is running, press Ctrl+H, which evokes the **Find and Replace** screen. In the **Find what** box enter a period (.) followed by two spaces and in the **Replace with** box enter a period followed by one space and then click on **Replace All**.



Finally, click on **Stop Recording** on the **Recording** toolbar.

To make it easy to engage the macro, place a macro button for that command on one of your toolbars or set a keyboard command. To create a button, click on **Toolbars**; to create a keyboard command, click on **Keyboard** (see screenshot below).

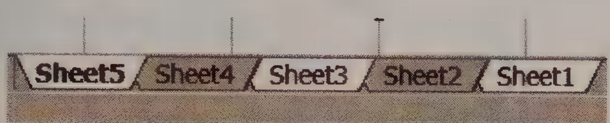


Important: In the **Store macro in** box be sure **All Documents (Normal.dot)** is showing. If not, engage the drop-down menu until it appears. Then follow the wizard's directions.

SEARCH MULTIPLE WORKSHEETS

Q I usually work with a spreadsheet that contains as many as 24 worksheets. When I do a search using the **Find** command, I have to repeat the command for each worksheet. Is there a way to command **Find** to search all the worksheets in one swoop?

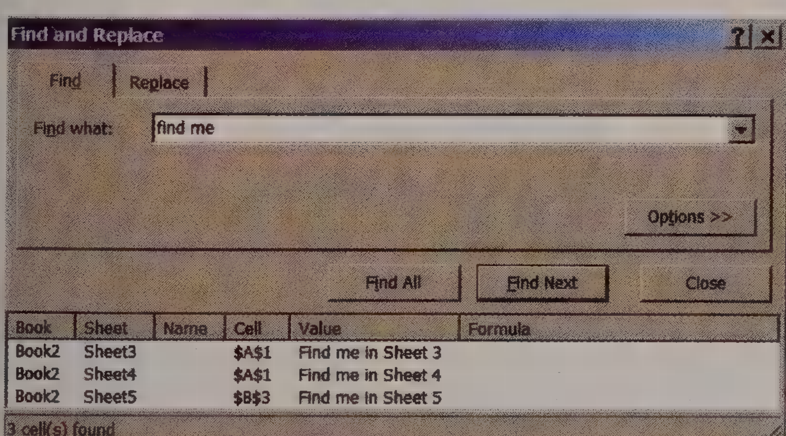
A Yes, not only can **Find** search all the worksheets in a file, it also can search across multiple worksheets. However, for a worksheet to be available for a search, it has to be open (as indicated by its color, as shown below). In the example below, Sheets 1, 3 and 5 are open.



"Wait a minute," you say, "I can't get more than one sheet open at a time."

Here's where a little Microsoft "sleight of hand" comes in handy. If you want all the sheets in a file to be opened, highlight the tab at either end; then, while holding down the Shift key, click the tab at the other end. To open just selected sheets, hold down the Ctrl key and click on the tabs of the sheets you want open.

Once you've got the target sheets opened, click on **Find**. To find them one at a time, click on **Find Next**. To find them all in one swoop, click on **Find All**, as shown in the screenshot below.

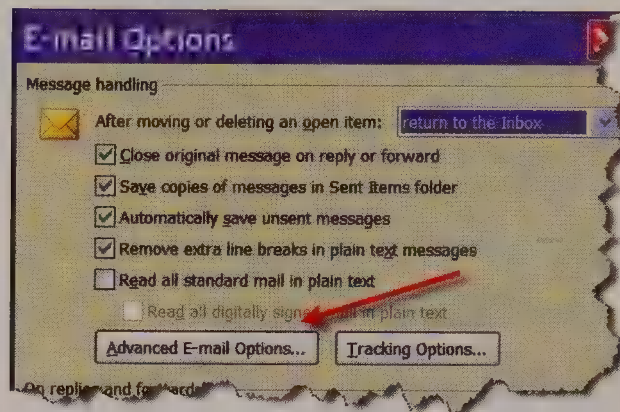


OUTLOOK HAS A "YOU'VE GOT MAIL" OPTION

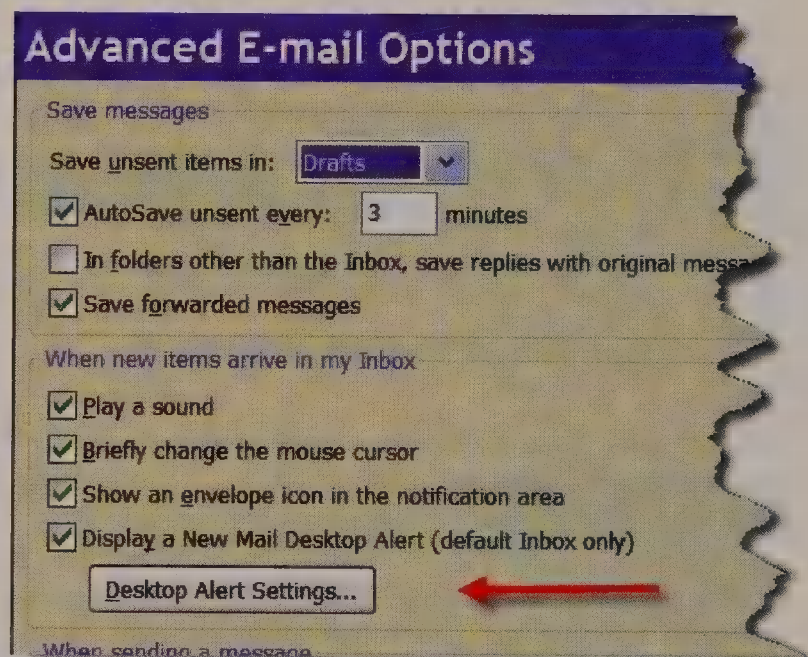
Q I get so wrapped up in my work that I often forget to check my incoming e-mail for hours at a time. Is there some way to program Outlook to give me a nudge or even ring a bell when a message comes in?

A Outlook does AOL's "You've Got Mail" option one better. It has several ways to alert you to new mail.

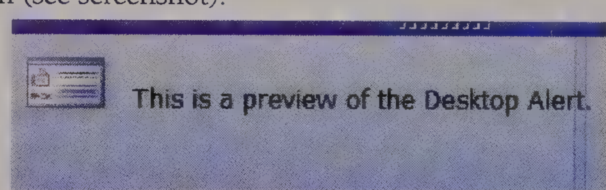
While in Outlook, click on **Tools**, **Options** and the **E-mail Options** button (see screenshot below).



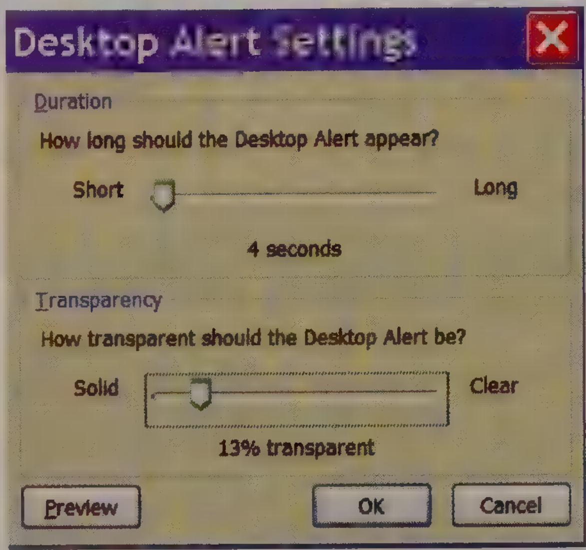
Then click on **Advanced E-mail Options**, which evokes a new screen with many more alerting options (as shown in the screenshot below).



Although I check them all, the most effective alert is the default selection: **Display ▪ New Mail Desktop Alert (default Inbox only)**. Each time an e-mail arrives, a message with the sender's name and subject appears on my screen for a few seconds. The message is transparent—that is, words behind it can be seen (see screenshot).

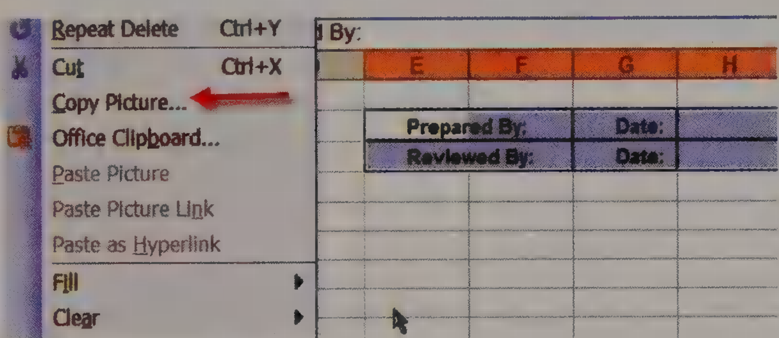


You can adjust the duration of the message, the level of transparency (see screenshot below) and move it anywhere on your screen just by dragging it. Test it by clicking on **Preview**.

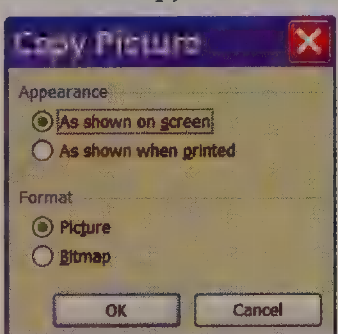


A BETTER WAY TO STAMP

In the December 2005 column, I suggested a way to place a stamp (*Prepared By: Reviewed By:*) in a spreadsheet. Reader Allison A. Schultz, CPA, CFO of Southern Aluminum, Magnolia, Ark., suggests an alternative method. After creating the stamp in Excel, highlight it and press Shift+Edit, bringing up this menu:

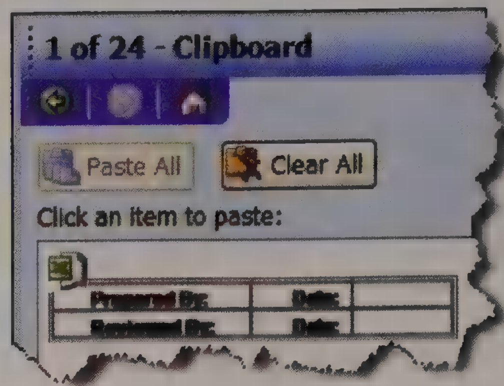


Click on **Copy Picture**, which evokes this screen:



Then click on **As shown on screen** and **Picture** and **OK**.

You now have two options: If you want to paste the stamp immediately, place your cursor where you want the stamp to appear and click on **Edit** and **Paste Special**. If you want to paste it later, highlight it and copy it (Ctrl+C). That will store it in the **Clipboard**, which you can evoke later by clicking on **Edit, Office Clipboard**.

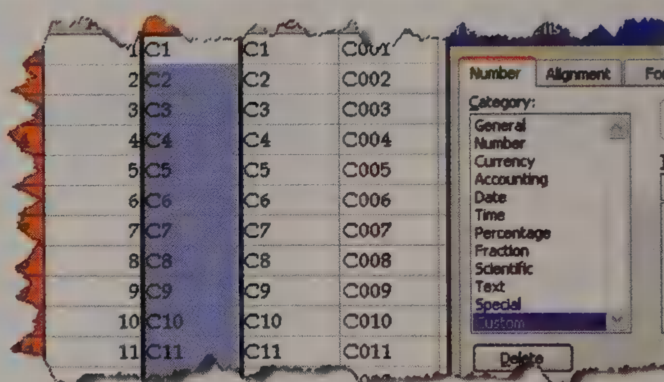


A GOOD IDEA

In the February 2006 item "Out, Out and Stay Out, You Stubborn Reviewing Toolbar," several readers correctly noted that the macro I suggested be recorded to **Personal Macro Workbook**, not **New Workbook**; in that way it can be accessed whenever needed.

ANOTHER BETTER WAY

In the February 2006 item "Overcome Excel's Sort Function Shortcoming," reader Rick Childs, CPA, CFA, a Crowe Chizek executive, suggests using Excel's custom format to overcome its **Sort** function limitation. He selects the 0 format category (see screenshot below) and then adds the necessary letters in front of the numerals. He also uses this method to add text after a nu-



meral, such as turning 17.0 in the 17.0x (a P/E number) or by adding the word Yrs. to numerals.

This method has a major advantage: Since the cell information still is a numeral, it can be both sorted and included in a formula. Now that's an elegant solution.

Stanley Zarowin, a former JofA *senior editor, is now a contributing editor. His e-mail address is zarowin@mindspring.com.*

Do you have technology questions for this column? Or, after reading an answer, do you have a better solution? Send them to contributing editor Stanley Zarowin via e-mail at zarowin@mindspring.com or regular mail at the *Journal of Accountancy*, 201 Plaza Three, Harborside Financial Center, Jersey City, NJ 07311-3881.

Because of the volume of mail, we regret we cannot individually answer submitted questions. However, if a reader's question has broad interest, I will answer it in a forthcoming Technology Q&A column.

On occasion you may find you cannot implement a function I describe in this column. More often than not it's because not all functions work in every operating system or application. I try to test everything in the 2000 and XP editions of Windows and Office. It's virtually impossible to test them in all editions and it's equally difficult to find out which editions are incompatible with a function. I apologize for the inconvenience.

What's Your Fraud IQ?

Think you know enough about corruption to spot it in any of its myriad forms? Then rev up your fraud detection radar and take this (deceptively) simple test.

by Joseph T. Wells

Questions

1. Which of the following is *not* a legal element of fraud?
- **a.** A material false statement.
- **b.** Intent.
- **c.** Reliance by the victim.
- **d.** All of the above are legal elements of fraud.

2. If a company adds fake sales to boost its revenues, the cost of sales as a percentage of revenue will increase.
- **a.** True.
- **b.** False.

3. On average, the most expensive asset misappropriations committed by a company's employees involve
- **a.** Inventory thefts.
- **b.** Cash larceny.
- **c.** Billing schemes.
- **d.** None of the above.

4. Statement on Auditing Standards (SAS) no. 99, *Consideration of Fraud in a Financial Statement Audit*, differs from its predecessor statement, SAS no. 82, in what material respect?
- **a.** It decreases the responsibility of auditors to detect fraud.
- **b.** It increases the liability for failing to detect fraud.
- **c.** It requires brainstorming about fraud risks prior to the audit.
- **d.** All of the above.

5. The most common method employees use to steal cash from an organization is
- **a.** Fraudulently billing for goods or services.
- **b.** Skimming money before it is entered into the books and records.
- **c.** Collusion between bookkeepers and cashiers.
- **d.** None of the above.

6. Financial statement frauds are most common in large companies.
- **a.** True.
- **b.** False.

7. On average the most expensive corruption scheme committed by employees of an organization is
- **a.** Bribes and kickbacks.
- **b.** Economic extortion.
- **c.** Undisclosed conflicts of interest.
- **d.** Accepting illegal gratuities.

8. The no. 1 method by which fraud is discovered in an organization is
- **a.** Analytical techniques.
- **b.** Accidental discoveries.
- **c.** Tips and complaints.
- **d.** None of the above.

9. The main reason employees commit occupational fraud is
- **a.** Poor internal controls.
- **b.** Greed.
- **c.** Personal financial problems.
- **d.** Dissatisfaction with the employer.

10. Executives in organizations are more honest than rank-and-file employees and are therefore less likely to commit fraud.
- **a.** True.
- **b.** False.

Answers

1. (*d*) Under common law there are four legal elements of fraud: a material false statement, intent, reliance on the false statement by the victim and damages.

2. (*b*) When a company adds fake sales to boost its revenue, the cost of sales remains the same, so cost of sales as a percentage of revenue will *decrease*.

3. (*c*) According to the Association of Certified Fraud Examiners' 2004 "Report to the Nation on Occupational Fraud and Abuse," billing schemes averaged $160,000 per occurrence; inventory thefts $132,500; and cash larceny $80,000.

4. (*c*) SAS no. 99 specifically requires brainstorming about fraud risks by the audit team; it does not decrease the responsibility of auditors to detect fraud nor increase liability for not detecting it.

5. (*a*) The most common methods employees use to steal cash from an organization are, in order: fraudulent disbursements, skimming and cash larceny.

6. (*b*) Despite the publicity generated by large frauds such as Enron and WorldCom, several studies have documented that the risk of financial statement fraud is higher in smaller companies.

7. (*a*) Bribes and kickbacks are the most expensive corruption schemes, averaging about $300,000 per offense. The others, in decreasing order of their average cost, are conflicts of interest, illegal gratuities and economic extortion.

8. (*c*) Numerous studies have concluded that tips and complaints are by far the most common way fraud is discovered in an organization, followed by accidental discoveries and, to a much lesser extent, analytical techniques.

9. (*d*) Although internal controls are important in deterring fraud, they provide only reasonable assurance, and there are few controls that cannot be circumvented by an employee determined to do so. In a landmark study of more than 10,000 workers by researchers Hollinger and Clark, dissatisfaction with their employer was the most common reason cited for committing fraud and theft.

10. (*b*) There is no difference in the level of honesty of employees and executives. What is different is the amount of the fraud loss; on average, the loss from a dishonest executive is 15 times that of a rank-and-file worker.

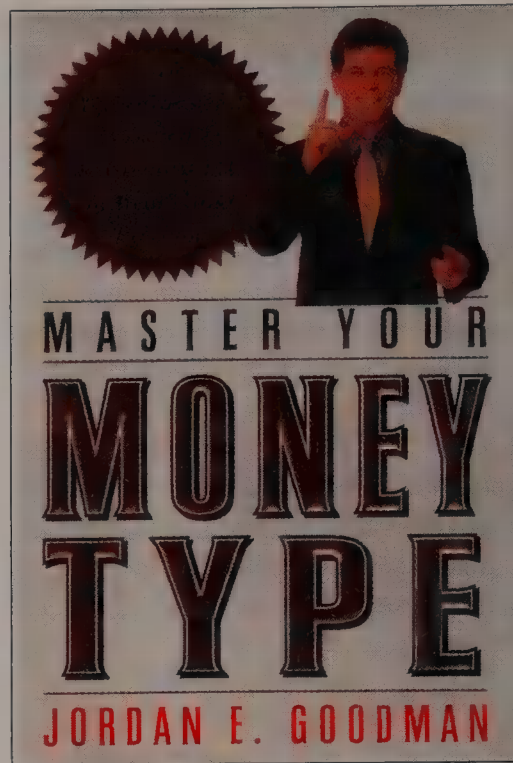
Joseph T. Wells, *CPA, CFE, is founder and chairman of the Association of Certified Fraud Examiners and a contributing editor to the* Journal. *He twice won the Lawler Award for the year's top article in the* JofA, *for which he was named to the* Journal of Accountancy *Hall of Fame. Wells is also a member of the Business and Industry Hall of Fame. His e-mail address is joe@cfenet.com. "The Report to the Nation on Occupational Fraud and Abuse" can be downloaded at* ***www.acfe.com/fraud/report.asp****.*

Business Bookshelf

Help clients make decisions based on the here and now.

by Barbara J. Shildneck

Master Your Money Type: Using Your Financial Personality to Create a Life of Wealth and Freedom
by Jordan E. Goodman
345 pages; hardcover; $24.95
Warner Business Books
New York, N.Y., 2006



Most people can characterize the way they handle money in familiar terms—big spender; penny-wise, pound-foolish; tightfisted. Jordan E. Goodman, however, views money management from a more complex angle.

After more than 25 years of radio and television financial commentary, lecturing and writing, Goodman realized he was giving the same financial advice to the same people again and again. This book is the fruit of his study of why clients kept repeating their financial mistakes. He found money behavior falls into six definable patterns, or "Money Types," and everyone has a predominant financial personality. A successful adviser must make clients aware of their individual money type to help them adopt behavior that allows them to enjoy their money.

Goodman says people's attitudes about money are colored by psychological factors. They "operate from experiences and messages given to them in [the] past." To find out more, he interviewed hundreds of volunteers about their financial problems and practices and prepared profiles of how people "care about, use, spend, invest, lose and earn money." For instance, one financial personality takes excessive risks; another denies money's importance; a third prefers to maintain the status quo. All exhibit clusters of characteristics in their feelings, fears and fantasies about money, the way they deal with money, the financial situations they get into and their ultimate financial goals.

Goodman devotes a chapter to each of the following six money types, tailoring practical financial advice to best fit the type's "personal emotional experience of money":

Strivers, who need to let others know how much they have. Great entrepreneurs, strivers may overspend—living beyond their means—and end up in debt. For them the heart of financial planning lies in cutting down on expenses and putting money aside.

Ostriches, who are intimidated or embarrassed by money and believe they cannot manage money basics. They need to learn how to help themselves and take charge of their finances.

Debt Desperadoes, who "prefer the thrill of buying to the security of having." Such shopaholics, who max out their credit cards and borrow to pay for essentials, have to work their way out of debt and learn to trust in their money management.

Coasters, who are financially stable but too complacent and therefore likely to bypass money-making opportunities. Goodman's money mastery technique: Make changes that provide better returns.

High Rollers, who relish gambling on high-stake deals (which often works to their advantage). Their weakness lies in taking risks without a safety net. They need to learn money management without "squelching risk-taking impulses."

Squirrels, who cheat themselves by hoarding their money out of fear of imminent destitution and loss of control over their lives. Goodman recommends they learn to enjoy money by investing it safely.

Each chapter begins with a money-type profile of strengths and weaknesses, fol-

lowed by several case studies illustrating problems specific to that financial personality. Goodman analyzes the details of each case, pointing out how the individual's actions have become habitual patterns in the Emotional Path section of the chapter. The Financial Path section explains how the type can make changes that build, rather than destroy, the financial future. Chapters conclude with Points to Remember and lists of resources (books, newsletters, organizations and Web sites) for that particular money type. The Appendix, "Taking Action: Where to Find Further Help," comprises 21 pages of additional resources that cover a broad, general spectrum.

> The book includes a hefty arsenal of worksheets, questionnaires and other aids to help readers define their financial goals.

The book includes a hefty arsenal of worksheets (monthly budgeting; assets, liabilities and cash flow; retirement expenses; annual retirement savings; and capital accumulation, for example), questionnaires and other aids to help readers define their financial goals. That guidance, along with the case studies, should benefit *Journal of Accountancy* readers whose clients or employees need advice explained to them in lay terms.

The author says he hopes readers will use the book to push the margins of their money types so they can make better informed decisions, learn how to operate from their strengths and to cease limiting their options and increase their level of comfort with money.

Emotions are the key. "To get serious about money," Goodman says, "always be aware of how your emotions set…into action…your behavior."

***Barbara J. Shildneck,** a former editor of the* JofA, *is now a contributing editor to the magazine.*

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Inside AICPA

New name for AICPA InfoBytes...Institute career Web site cited for superior quality...Directory of member services

AICPA InfoBytes Becomes *CPExpress*

The AICPA's popular online learning library has a new name and user interface, as well as enhanced functions. The CPE product's improved features include an easy-to-use catalog; new categories, such as "hot" topics, annual updates, accounting and auditing and taxation; easier access to courses; and customizable views of a user's progress in a course. For additional information or to subscribe to *CPExpress*, go to **www.cpa2biz.com/cpexpress** or call 888-777-7077.

Institute Career Site Earns Laurels

"The Turnaround Game" (**www.theturnaroundgame.com**), a Web-based interactive business simulation the Institute developed to introduce students to the CPA's role in business, won a Web Marketing Association 2006 Internet Advertising Competition Award for the best nonprofit interactive application. The site is the latest installment in the Institute's Start Here, Go Places student recruitment campaign (**www.startheregoplaces.com**), an ongoing series of promotions, contests, games and simulations. ❖

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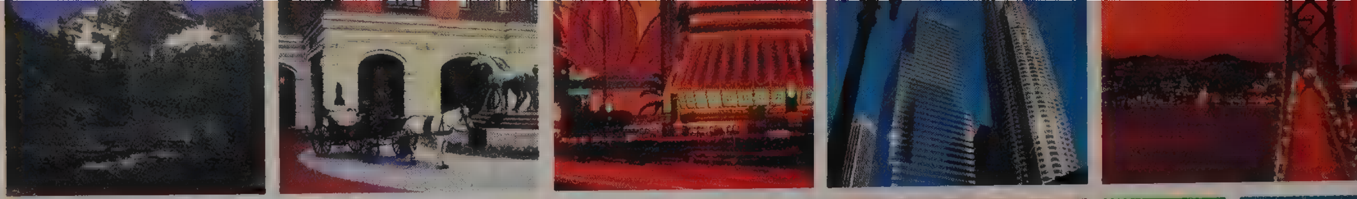

Exposure Drafts Outstanding

(This list was compiled as of June 1, 2006. For exposure drafts issued after that date, consult *The CPA Letter*.
Note: The policy for updating the list of exposure drafts is that a document should remain on the list until a final document has been issued or the project has been dropped. However, no comments will be received after the comments deadline has expired. The list is not all-inclusive but is intended to present the exposure drafts of particular interest to professional accountants.)

Issue Date	Title or Description	Comment Deadline
FASB		
5/26/06	**Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting**	8/24/06
3/31/06	Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106 and 132(R)	5/31/06
1/25/06	The Fair Value Option for Financial Assets and Financial Liabilities (including an amendment of FASB Statement No. 115)	4/10/06
9/30/05	Selected Issues Relating to Assets and Liabilities with Uncertainties	1/3/06
9/30/05	Earnings per Share—an amendment of FASB Statement No. 128 (revision of Exposure Draft issued 12/15/03)	11/30/05
8/11/05	Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140	10/10/05
7/14/05	Accounting for Uncertain Tax Positions—an interpretation of FASB Statement No. 109	9/12/05
6/30/05	Business Combinations—a replacement of FASB Statement No. 141	10/28/05
6/30/05	Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries—a replacement of ARB No. 51	10/28/05
4/28/05	The Hierarchy of Generally Accepted Accounting Principles	6/27/05
6/23/04	Fair Value Measurements	9/7/04
AcSEC (AICPA)		
6/19/03	Proposed Statement of Position, Allowance for Credit Losses	9/19/03
12/17/02	Proposed Statement of Position, Clarification of the Scope of the Audit and Accounting Guide Audits of Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investment in Investment Companies	3/31/03
ASB (AICPA)		
3/6/06	Proposed Statement on Auditing Standards, *The Auditor's Communication With Those Charged With Governance*	5/31/06
1/19/06	Proposed Statement on Standards for Attestation Engagements: Reporting on an Entity's Internal Control Over Financial Reporting	5/19/06
5/9/05	Proposed Statement on Auditing Standards: Amendment to Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles, for Nongovernmental Entities	6/27/05
OTHER (AICPA)		
12/30/05	Proposed Statement on Standards for Tax Services No. 9, "Quality Control"	8/31/06
9/15/05	Omnibus Proposal of Professional Ethics Division Interpretations and Rulings	12/16/05
9/20/04	XBRL US Financial Reporting Taxonomy Framework	11/19/04
11/1/01	AICPA/NASBA Uniform Accountancy Act and Uniform Accountancy Act Rules	12/31/01
3/7/01	Statement on Standards for Continuing Professional Education Programs	8/1/01
SEC		
6/26/02	Framework for Enhancing the Quality of Financial Information Through Improvement of Oversight of the Auditing Process; Release Nos. 33-8109; 34-46120; 35-27543; IA-2039; IC-25624	9/3/02
5/10/02	Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies (Release Nos. 33-8098; 34-45907)	7/19/02
4/12/02	Form 8-K Disclosure of Certain Management Transactions; Release No. 33-8090	6/24/02
4/12/02	Form 8-K Disclosure of Certain Management Transactions; Release No. 34-45742	6/24/02
2/18/00	SEC Concept Release: International Accounting Standards	5/23/00
1/21/00	Supplementary Financial Information	4/17/00
GASB		
4/28/06	Accounting and Financial Reporting for Derivatives (Preliminary Views)	7/28/06
2/17/06	Accounting and Financial Reporting by Employers and OPEB Plans for Payments from the Federal Government Pursuant to the Provisions of Medicare Part D (Proposed Technical Bulletin)	4/17/06
1/31/06	Accounting and Financial Reporting for Pollution Remediation Obligations	5/1/06
9/30/05	Sales and Pledges of Receivables and Future Revenues	12/30/05
IFAC		
3/24/06	Proposed International Standard on Auditing 600 (Revised and Redrafted), "The Audit of Group Financial Statements"	7/31/06
1/30/06	Proposed International Public Sector Accounting Standard, "Revenue from Non-Exchange Transactions (Including Taxes and Transfers)"	6/30/06

*New additions appear in **bold** type.*

EXPOSURE DRAFTS OUTSTANDING

Issue Date	Title or Description	Comment Deadline
6/30/05	Proposed International Standard on Auditing 701, "The Independent Auditor's Report on Other Historical Financial Information"	10/31/05
6/30/05	Proposed International Standard on Auditing 800, "The Independent Auditor's Report on Summary Audited Financial Statements"	10/31/05
10/11/05	Presentation of Budget Information in Financial Statements	2/10/06
10/11/05	Disclosure of Financial Information about the General Government Sector	2/10/06
10/31/05	International Standard on Auditing, ISA 240 (Redrafted), "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements"	2/28/06
10/31/05	ISA 300 (Redrafted), "Planning an Audit of Financial Statements"	2/28/06
10/31/05	ISA 315 (Redrafted), "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement"	2/28/06
10/31/05	ISA 330 (Redrafted), "The Auditor's Procedures in Response to Assessed Risks"	2/28/06
9/23/05	Improvements to International Public Sector Accounting Standards	1/31/06
9/23/05	Equal Authority of Paragraphs in IPSASs	1/31/06
4/15/05	Proposed International Education Standard for Professional Accountants, "Competence Requirements for Audit Professionals"	7/15/05
3/22/05	Proposed International Standard on Auditing 600 (Revised), "The Audit of Group Financial Statements"	7/31/05
3/22/05	Proposed ISA 260 (Revised), "The Auditor's Communication with Those Charged with Governance"	7/31/05
3/22/05	Proposed ISA 705 and ISA 706, "Modifications to the Opinion in the Independent Auditor's Report and Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report"	7/31/05
2/4/05	Proposed International Public Sector Accounting Standard, "Financial Reporting Under the Cash Basis of Accounting—Disclosure Requirements for Recipients of External Assistance"	6/15/05
12/20/04	Proposed ISA 320 (Revised), "Materiality in the Identification and Evaluation of Misstatements"	4/30/05
12/20/04	Proposed ISA 540 (Revised), "Auditing Accounting Estimates and Related Disclosures (Other than Those Involving Fair Value Measurements and Disclosures)"	4/30/05
9/23/04	Policy Statement, "Clarifying Professional Requirements in International Standards" and Consultation Paper, "Improving the Clarity and Structure of IAASB Standards and Related Considerations for Practice Statements"	12/31/04
7/14/04	Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services—IAASB Due Process and Working Procedures	10/15/04
1/20/04	Accounting for Social Policies of Governments	6/30/04
12/23/03	ISA 600 (Revised), "The Work of Related Auditors and Other Auditors in the Audit of Group Financial Statements" and IAPS, "The Audit of Group Financial Statements"	3/31/04

FASAB

Issue Date	Title or Description	Comment Deadline
6/1/06	**Technical Bulletin 2006-1, "Recognition and Measurement of Asbestos-Related Cleanup Costs"**	6/30/06
10/27/05	Consolidated Financial Report of the United States Government Requirements: Implementing Statement of Federal Financial Accounting Concepts 4 "Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government"	3/1/06
6/27/05	Accounting for Fiduciary Activities (Revised)	8/30/05

PCAOB

At the present time PCAOB exposure drafts have very short comment periods. A list of outstanding PCAOB exposure drafts is available online at **www.pcaobus.org**.

INFORMATION

The initials stand for the following organizations. Exposure drafts are available online at the Web addresses below or copies may be obtained at the address in parentheses (unless otherwise indicated).

FASB– Financial Accounting Standards Board (Order Department, Financial Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116); also available online at **www.fasb.org**

GASB– Governmental Accounting Standards Board (Order Department, Governmental Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116); also available online at **www.gasb.org**

AICPA– American Institute of CPAs (American Institute of Certified Public Accountants, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881). AICPA publishes exposure drafts exclusively on the Web site at **www.aicpa.org**. Print copies are not available.

IASB– International Accounting Standards Board (International Accounting Standards Board, 30 Cannon Street, London EC4M 6XH, United Kingdom), also available online at **www.iasb.org.uk**

IFAC– International Federation of Accountants (International Federation of Accountants, 545 Fifth Avenue, 14th Floor, New York, NY 10017); also available online at **www.ifac.org**

SEC– Securities and Exchange Commission (Securities and Exchange Commission, 450 5th Street, N.W., Washington, DC 20549); also available online at **www.sec.gov**

FASAB– Federal Accounting Standards Advisory Board (Federal Accounting Standards Advisory Board, 441 G Street, N.W., Suite 6814, Washington, DC 20548); also available online at **www.fasab.gov**

GAO– U.S. Government Accountability Office (Government Auditing Standards Comments, Marcia B. Buchanan, U.S. General Accounting Office, Room 5089, 441 G Street, N.W., Washington, DC 20548); **www.gao.gov**

PCAOB– Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, DC 20006-2803; info@pcaobus.org

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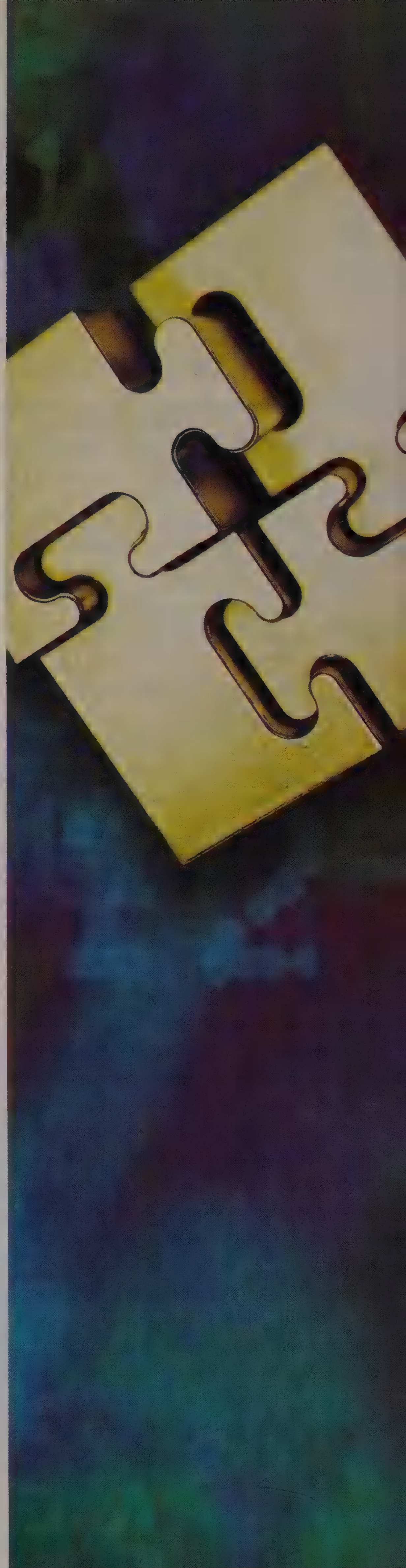

Official Releases

SAS NO. 112

SAS NO. 112

Communicating Internal Control Related Matters Identified in an Audit

(Supersedes Statement on Auditing Standards No. 60, **Communication of Internal Control Related Matters Noted in an Audit,** *as amended, AICPA,* **Professional Standards.***)*

INTRODUCTION

1. This Statement on Auditing Standards (SAS) establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements. It is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion). In particular, this SAS:

- Defines the terms *significant deficiency* and *material weakness*.
- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements.
- Requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit.

2. The term *those charged with governance* is defined in footnote 5 of SAS No. 103, *Audit Documentation*, as "the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting and disclosure process." In most entities, governance is a collective responsibility that may be carried out by a board of directors, a committee of the board of directors (for example, an audit or legislative oversight committee), a committee of management (for example, a finance, budget, or governmental agency executive committee), partners, equivalent persons, or some combination of these parties. In some smaller entities, management and those charged with governance may be the same people, for example, the owner in an owner-managed entity or a sole trustee.

3. Internal control is a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls related to financial reporting and operations objectives. Generally, controls that are relevant to an audit of financial statements are those that pertain to the entity's objective of reliable financial reporting. In this Statement, the term *financial reporting* relates to the preparation of reliable financial statements that are fairly presented in conformity with generally accepted accounting principles.[1] The design and formality of an entity's internal control will vary depending on the entity's size, the industry in which it operates, its culture, and management's philosophy.

4. In an audit of financial statements, the auditor is not required to perform procedures to identify deficiencies in internal control[2, 3] or to express an opinion on the effectiveness of the entity's internal control.[4] However, during the course of an audit, the auditor may become aware of control deficiencies while obtaining an understanding of the entity's internal control, assessing the risks of material misstatement of the financial statements due to error or fraud, performing further audit procedures to respond to assessed risk, communicating with management or others (for example, internal auditors or governmental authorities), or otherwise. The auditor's awareness of control deficiencies varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed, as well as other factors.

DEFINITIONS

5. A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A deficiency in *design* exists when (*a*) a control necessary to meet the control objective is missing or (*b*) an existing control is not properly designed so that even if the control operates as designed, the control objective is not always met. A deficiency in *operation* exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively. Control deficiencies may involve one or more of the five interrelated components of internal control.

6. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood[5] that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

7. The phrase "more than inconsequential" as used in the definition of significant deficiency describes the magnitude of potential misstatement that could occur as a result of a significant defi-

1. Reference to generally accepted accounting principles includes, where applicable, a comprehensive basis of accounting other than generally accepted accounting principles, as that term is defined in paragraph 4 of Statement on Auditing Standards (SAS) No. 62, *Special Reports*, as amended.
2. Hereinafter in this Statement, the term *internal control* means internal control over financial reporting.
3. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended, contains a detailed discussion of internal control and the following five interrelated components of internal control: (*a*) the control environment, (*b*) risk assessment, (*c*) control activities, (*d*) information and communication, and (*e*) monitoring.
4. The auditor's responsibility for communicating matters related to an entity's internal control identified in an audit of financial statements is not the same as the practitioner's responsibility for reporting on the effectiveness of an entity's internal control in an attestation engagement performed under Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification*.
5. The term *remote likelihood* as used in the definitions of the terms *significant deficiency* and *material weakness* has the same meaning as the term *remote* as used in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. Paragraph 3 of FASB Statement No. 5 states:

> When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:
> a. *Probable*. The future event or events are likely to occur.
> b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
> c. *Remote*. The chance of the future events or events occurring is slight.

Therefore, the likelihood of an event is "more than remote" when it is at least reasonably possible.

Correction

In the April issue a heading for an ethics ruling on page 104 in Official Releases incorrectly read "Ethics Ruling 183 Under Rule 501." It should have said "Ethics Ruling 189 Under Rule 501."

ciency and serves as a threshold for evaluating whether a control deficiency or combination of control deficiencies is a significant deficiency. A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person would not reach such a conclusion regarding a particular misstatement, that misstatement is more than inconsequential.

8. In determining whether a potential misstatement would be more than inconsequential, the auditor should consider qualitative and quantitative factors. Inconsequential in this context is not the same concept as the threshold amount the auditor establishes in an audit of financial statements below which known and likely misstatements need not be accumulated. For example, for the purposes of evaluating control deficiencies, a potential misstatement that is less than 20 percent of overall financial statement materiality may be considered inconsequential, before considering qualitative factors. However, a potential misstatement that is less than 20 percent of overall financial statement materiality may be considered more than inconsequential as a result of qualitative factors.[6]

EVALUATING CONTROL DEFICIENCIES IDENTIFIED AS PART OF THE AUDIT

9. The auditor must evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses. The significance of a control deficiency depends on the potential for a misstatement, not on whether a misstatement actually has occurred. Accordingly, the absence of identified misstatement does not provide evidence that identified control deficiencies are not significant deficiencies or material weaknesses.

10. When evaluating whether control deficiencies, individually or in combination, are significant deficiencies or material weaknesses, the auditor should consider the likelihood and magnitude of misstatement.

11. The following are examples of factors that may affect the likelihood that a control, or combination of controls, could fail to prevent or detect a misstatement:

- The nature of the financial statement accounts, disclosures, and assertions involved. For example, suspense accounts and related party transactions involve greater risk.
- The susceptibility of the related assets or liabilities to loss or fraud.
- The subjectivity and complexity of the amount involved, and the extent of judgment needed to determine that amount.
- The cause and frequency of any known or detected exceptions related to the operating effectiveness of a control.
- The interaction or relationship of the control with other controls.
- The interaction of the control deficiency with other control deficiencies.
- The possible future consequences of the deficiency.

12. Several factors affect the magnitude of a misstatement that could result from a deficiency or deficiencies in controls. The factors include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency.
- The volume of activity in the account balance or class of transactions exposed to the deficiency in the current period or expected in future periods.

The maximum amount by which an account balance or total of transactions can be overstated generally is the recorded amount. However, because of the potential for unrecorded amounts, the recorded amount is not a limitation on the amount of potential understatement.

13. Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness, even though such deficiencies are individually insignificant. Therefore, the auditor should evaluate individual control deficiencies that affect the same account balance, disclosure, relevant assertion, or component of internal control, to determine whether they collectively result in a significant deficiency or material weakness.

14. In determining whether a control deficiency or combination of control deficiencies is a significant deficiency or material weakness, the auditor also should evaluate the possible mitigating effects of effective compensating controls that have been tested and evaluated as part of the financial statement audit. A compensating control is a control that limits the severity of a control deficiency and prevents it from rising to the level of a significant deficiency or, in some cases, a material weakness. Compensating controls operate at a level of precision, considering the possibility of further undetected misstatements, that would result in the prevention or detection of a misstatement that is more than inconsequential or material to the financial statements. Although compensating controls mitigate the effects of a control deficiency, they do not eliminate the control deficiency.

15. The auditor's evaluation of the possible mitigating effects of compensating controls can be illustrated by the following example, in which an owner-managed entity does not segregate duties within the accounts payable function. As a compensating control, the owner reviews the supporting documentation for all disbursements exceeding $1,000. The auditor could evaluate the effect of this compensating control and determine whether it operates effectively for the purpose of mitigating the effects of the control deficiency in the accounts payable function (the lack of segregation of duties).

16. In an audit in which the auditor has decided to test the operating effectiveness of controls, the auditor may encounter deviations in the operation of those controls. A control that has an observed nonnegligible deviation rate is a deficiency regardless of the reason for the deviation. For example, if the auditor designs a test in which he or she selects a sample and expects no deviations, the finding of one deviation is a nonnegligible deviation rate because, based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.

17. The auditor should conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.

18. Deficiencies in the following areas ordinarily are at least significant deficiencies in internal control:

- Controls over the selection and application of accounting principles that are in conformity with generally accepted accounting principles. Having sufficient expertise in selecting and applying accounting principles is an aspect of such controls.
- Antifraud programs and controls.
- Controls over nonroutine and nonsystematic transactions.
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements.

19. Each of the following is an indicator of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control:

- Ineffective oversight of the entity's financial reporting and internal control by those charged with governance.
- Restatement of previously issued financial statements to reflect the correction of a material misstatement. (The correction of a misstatement includes misstatements due to error or fraud; it does not include restatements to reflect a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle.)
- Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the entity's internal control. This includes misstatements involving estimation and judgment for which the auditor identifies likely material adjustments and corrections of the recorded amounts. (This is a strong indicator of a material weakness even if management subsequently corrects the misstatement.)
- An ineffective internal audit function or risk assessment function at an entity for which such functions are important to the monitoring or risk assessment component of internal control, such as for very large or highly complex entities.

6. Interpretation No. 4, "Considering the Qualitative Characteristics of Misstatements," of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended, identifies qualitative factors an auditor may consider in determining whether a misstatement is material.

• For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of the ineffective regulatory compliance function for which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.

• Identification of fraud of any magnitude on the part of senior management. (The auditor has a responsibility to plan and perform procedures to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by error or fraud.[7] However, for the purposes of evaluating and communicating deficiencies in internal control, the auditor should evaluate fraud of any magnitude—including fraud resulting in immaterial misstatements—on the part of senior management, of which he or she is aware.)

• Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected. See paragraph 20 for communication requirements in these circumstances.

• An ineffective control environment. Control deficiencies in various other components of internal control could lead the auditor to conclude that a significant deficiency or material weakness exists in the control environment.

See the Appendix of this Statement for examples of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses.

COMMUNICATION–FORM, CONTENT, AND TIMING

20. Control deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses under this Statement must be communicated in writing to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits, and have not yet been remediated. (Significant deficiencies and material weaknesses that previously were communicated and have not yet been remediated may be communicated in writing by referring to the previously issued written communication and the date of that communication.)

21. The written communication referred to in paragraph 20 is best made by the report release date, which is the date the auditor grants the entity permission to use the auditor's report in connection with the financial statements, but should be made no later than 60 days following the report release date. See paragraph 23 of SAS No. 103 for additional guidance related to the report release date.

22. For some matters, early communication to management or those charged with governance may be important. Accordingly, the auditor may decide to communicate certain identified significant deficiencies and material weaknesses during the audit. If the communication is made during the audit, the form of interim communication would be affected by the relative significance of the identified control deficiencies and the urgency for corrective follow-up action. Such early communication is not required to be in writing. However, regardless of how the early communication is delivered, the auditor must communicate all significant deficiencies and material weaknesses in writing to management and those charged with governance in accordance with paragraphs 20 and 21.

23. The existence of significant deficiencies or material weaknesses may already be known to management and may represent a conscious decision by management or those charged with governance to accept that degree of risk because of cost or other considerations. Management is responsible for making decisions concerning costs to be incurred and related benefits. The auditor's responsibility to communicate significant deficiencies and material weaknesses in accordance with paragraph 20 exists regardless of management's decisions.

24. Nothing precludes the auditor from communicating to management and those charged with governance other matters that the auditor:

• Believes to be of potential benefit to the entity, such as recommendations for operational or administrative efficiency, or for improving internal control.

• Has been requested to communicate, for example, control deficiencies that are not significant deficiencies or material weaknesses.

Such matters may be communicated either orally or in writing. If the information is communicated orally, the auditor should document the communication.

25. The written communication regarding significant deficiencies and material weaknesses identified during an audit of financial statements should:

• State that the purpose of the audit was to express an opinion on the financial statements, but not to express an opinion on the effectiveness of the entity's internal control over financial reporting.

• State that the auditor is not expressing an opinion on the effectiveness of internal control.

• Include the definition of the terms *significant deficiency* and, where relevant, *material weakness*.

• Identify the matters that are considered to be significant deficiencies and, if applicable, those that are considered to be material weaknesses.

• State that the communication is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. If an entity is required to furnish such auditor communications to a governmental authority, specific reference to such governmental authorities may be made.

26. The following is an illustrative written communication encompassing the requirements in paragraph 25.

In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered ABC Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies [*and other deficiencies that we consider to be material weaknesses*].

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the following deficiencies to be significant deficiencies in internal control:

[*Describe the significant deficiencies that were identified.*]

[*A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. We believe that the following deficiencies constitute material weaknesses.*]

[*Describe the material weaknesses that were identified.*]

This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, and [*identify any specified governmental authorities*] and is not intended to be and should not be used by anyone other than these specified parties.

27. If the auditor wishes, he or she may include additional statements in the communication regarding the general inherent *(continued on page 102)*

7. SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, provides guidance on the auditor's responsibilities for planning and performing the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement whether caused by error or fraud.

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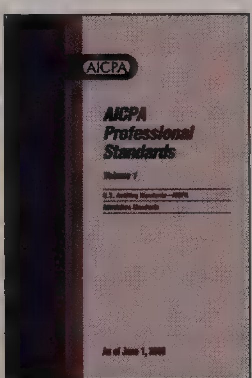

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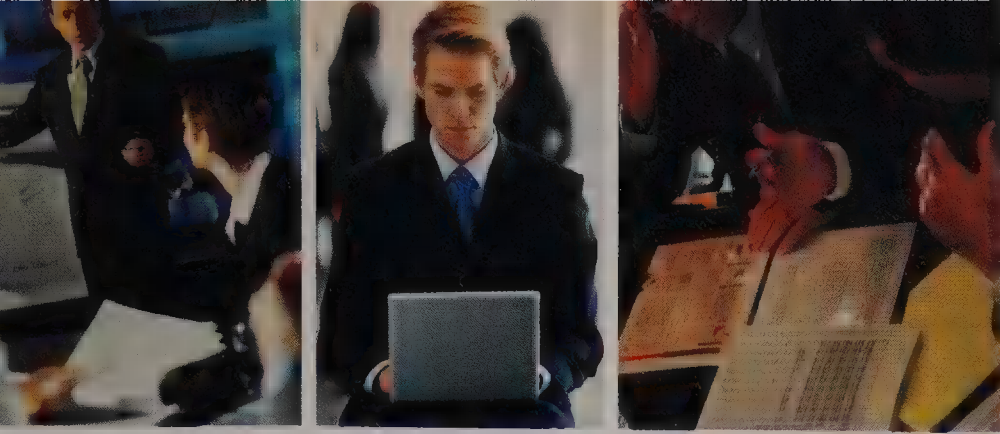

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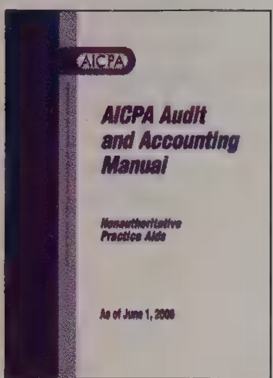

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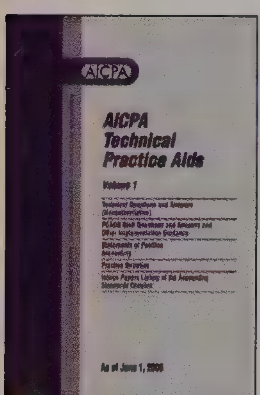

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limitations of internal control, including the possibility of management override of controls, or the specific nature and extent of the auditor's consideration of internal control during the audit.

28. A client may ask the auditor to issue a communication indicating that no material weaknesses were identified during the audit of the financial statements for the client to submit to governmental authorities. The following is an illustrative communication that may be used when the auditor has not identified any material weaknesses and wishes, or has been requested, to advise management and those charged with governance that no material weaknesses were identified.[8]

> In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered ABC Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.
>
> A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.
>
> A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.
>
> Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above.
>
> This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, and [*identify any specified governmental authorities*] and is not intended to be and should not be used by anyone other than these specified parties.

If one or more significant deficiencies have been identified, the auditor may add the following sentence to the fourth paragraph of the communication:

> However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on [*date*].

29. The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

30. Management may wish to, or may be required by a regulator to, prepare a written response to the auditor's communication regarding significant deficiencies or material weaknesses identified in the audit. Such management communications may include a description of corrective actions taken by the entity, the entity's plans to implement new controls, or a statement indicating that management believes the cost of correcting a significant deficiency or material weakness would exceed the benefits to be derived from doing so. If such a written response is included in a document containing the auditor's written communication to management and those charged with governance concerning identified significant deficiencies or material weaknesses, the auditor should add a paragraph to his or her written communication disclaiming an opinion on such information. Following is an example of such a paragraph.

> ABC Company's written response to the significant deficiencies [*and material weaknesses*] identified in our audit has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

EFFECTIVE DATE

31. This Statement is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier implementation is permitted.

APPENDIX

EXAMPLES OF CIRCUMSTANCES THAT MAY BE CONTROL DEFICIENCIES, SIGNIFICANT DEFICIENCIES, OR MATERIAL WEAKNESSES

Paragraph 18 of this Statement identifies areas in which control deficiencies ordinarily are at least significant deficiencies, and paragraph 19 identifies indicators that a control deficiency should be regarded as at least a significant deficiency and a strong indicator of a material weakness. The following are examples of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses.

Deficiencies in the Design of Controls

- Inadequate design of internal control over the preparation of the financial statements being audited.
- Inadequate design of internal control over a significant account or process.
- Inadequate documentation of the components of internal control.
- Insufficient control consciousness within the organization, for example, the tone at the top and the control environment.
- Absent or inadequate segregation of duties within a significant account or process.
- Absent or inadequate controls over the safeguarding of assets (this applies to controls that the auditor determines would be necessary for effective internal control over financial reporting).
- Inadequate design of information technology (IT) general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
- Employees or management who lack the qualifications and training to fulfill their assigned functions. For example, in an entity that prepares financial statements in accordance with generally accepted accounting principles, the person responsible for the accounting and reporting function lacks the skills and knowledge to apply generally accepted accounting principles in recording the entity's financial transactions or preparing its financial statements.
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity's internal control over time.
- The absence of an internal process to report deficiencies in internal control to management on a timely basis.

Failures in the Operation of Internal Control

- Failure in the operation of effectively designed controls over a significant account or process, for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process.
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy, for example, the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements.
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. This circumstance may need careful consideration before it is evaluated as a significant deficiency or material weakness. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. Although the physical inventory count does not safe-

8. If an examination of internal control under Chapter 5 of SSAE No. 10 (AT sec. 501) was performed for the same period or "as of" date as the audit of the financial statements, the issuance of a report indicating that no material weaknesses had been identified during the audit of the financial statements would not be appropriate.

guard the inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely. Therefore, given that the definitions of material weakness and significant deficiency relate to likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. Material weaknesses relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.

- Failure to perform reconciliations of significant accounts. For example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.
- Undue bias or lack of objectivity by those responsible for accounting decisions, for example, consistent understatement of expenses or overstatement of allowances at the direction of management.
- Misrepresentation by client personnel to the auditor (an indicator of fraud).
- Management override of controls.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.

This Statement entitled Communicating Internal Control Related Matters Identified in an Audit *was unanimously adopted by the assenting votes of the 19 members of the board.*

Note: *Statements on Auditing Standards are issued by the Auditing Standards Board, the senior technical body of the Institute designated to issue pronouncements on auditing matters. Rule 202,* Compliance With Standards, *of the Institute's Code of Professional Conduct requires compliance with these standards in an audit of a nonissuer.*

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Financial Manager wanted by men and women's chain store in Reading, Pennsylvania. Must have Bachelor's degree in Business Administration plus 5 years experience in related field. Apply to: **Against All Odds USA, Inc., 3050 North 5th Street, Reading, PA 19605**.

Budget Analyst wanted by urban apparels chain stores in Reading, Pennsylvania. Must have Bachelor's Degree in Business Administration. Apply to: **Against All Odds USA, Inc., 3050 North 5th Street, Reading, PA 19605**.

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Accounting Manager, CPA firm. Experienced write up and tax. Ft. Lauderdale area. Great opportunity. Partnership potential. Fax resume: **(954) 452-8359, Attention: Frank. fgutta@gkrcpas.biz**

Financial Manager/Accountant sought by real estate firm for full-time, permanent position in Burbank, California. Requires Bachelor's in Math, Accounting, Finance or related field, plus 2 years experience. **2000R Corporation DBA Atlas Real Estate & Financing Group, Attention: Razmik Tatos, CEO, 290 East Verdugo Avenue, Suite 104, Burbank, CA 91502**.

Accountant sought by CPA firm located in Garden Grove, California. Bachelor's degree or equivalent in Accounting or Economics plus 6 months experience required in accounting/auditing and tax auditing and preparation. Mail resume to: **Joseph S. Ro, CPA, 9681 Garden Grove Boulevard, #205, Garden Grove, CA 92844**.

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Financial Analyst, New York, New York – Manage, analyze and monitor flow of cash and financial information. BA or foreign equivalent in Accounting/Finance and related experience. Resume: **Rabinder Singh, Surrey Hotel Associates, LLC; dba Dream, 210 West 55th Street, New York, NY 10019.**

George Johnson & Company, P.C. seeks full-time Auditor to work in Detroit, Michigan. Will compile, review and audit financial statements, among other financial activities. Must have M.B.A. in Accounting, or related fields. Must have CPA license or passed the exam. Submit resumes to: **Chandra Marshall, 535 Griswold Street, Suite 1200, Detroit, MI 48226**. Fax: **(313) 965-4614**.

Financial Analyst, New York, New York – Manage, analyze and monitor flow of cash and financial information. BA or foreign equivalent. Accounting/Finance and related experience. Resume: **One Hour Framing, Inc., 131 West 45th Street, New York, NY 10036**.

Accountant – Self-motivated. BA Accounting plus 2 years experience needed by jewelry importer/wholesaler. Resume to: **Sincere Jewelry, Inc., 7161 SW 117th Avenue, Miami, FL 33183; Attn: HR**.

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Senior Accountant – University Medical Center of Southern Nevada, (UMC) located in Las Vegas, Nevada has an exceptional opportunity available in the Fiscal Services Department for an experienced Senior Accountant. The Sr. Accountant will act as lead, participate in the preparation of financial and operating reports, perform audit support and ensure accurate and timely recording of accounting information within generally accepted accounting principles (GAAP). You will also be responsible for performing complex, sensitive and specialized professional-level analyses for hospital programs and activities. The successful candidate will have a Master's degree or equivalent in Accounting, Finance or a closely related field and two (2) years of professional level experience in performing administrative, operational or similar analyses and studies. Candidates with a CPA and/or public accounting experience is preferred. UMC offers competitive salaries, an excellent benefit package, including no state or social security tax, and an employer paid retirement program. For immediate consideration, please apply online at: **www.umcsn.com** or email your resume to: **Shirley.Phillips@umcsn.com**. For additional information, please call: **(800) 228-2354**.

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Accountant – Closter, New Jersey. Examine, direct and perform all accounting, finance and administrative functions, including accounts payable, receivable, billing, general ledger, inventory, third party administration and cash management, financial statement preparation and analysis, financial reporting analysis and budgeting, tax and GAAP compliance, implementation of accounting and administrative controls, analyze and formulate accounting strategies and policies, installation of computerized account and budgeting system, coordinate with various external consultants/specialists on matters related to automation of reports, payroll, internal audit to prevent waste and recommend cost-saving alternative and solutions to company's financial problems. Bachelor's degree in Accounting or related field plus 2 years experience. Strong analytical, computing and communication skills. Send resume to: **American Key Products, Inc., 1 Reuten Drive, Closter, NJ 07624**.

A worldwide audio engineering institute is seeking an Accountant to perform the following duties: handle in-house budgets, finance activities and consolidated accounts for New York, Miami, Nashville and Los Angeles locations to include general ledgers, balance sheets, profit and loss statements and variance analysis. Reconcile student accounts; audit contracts, invoices and expenditures; set up internal audit controls for all school locations, supervise payroll and benefit costs, use of MAS 90 for accounting functions, FilemakerPro for student account information, include unearned tuition, MS Office and Excel for macros, charts, spreadsheets, InDesign and Photoshop for Education department registration reviews. Handle transfer pricing of equipment between locations, reconcile inter-company accounts in multi-currencies, consolidate purchases and advertising rates for group of schools, audit office space contracts. A BA or U.S. evaluated equivalent in Accounting is required and 2 years relevant accounting/auditing experience in international environment. Send confidential resume to: **Vice President, SAE Institute Group, 1293 Broadway, 9th Floor, New York, NY 10001**.

Accountant – Self-motivated person needed by luggage importer. BA Accounting plus 2 years. Resume to: **Teak Imports Int'l; dba Kangaroo Pouch, 201 Skylane Road, McKinnon Industrial Park, St. Simons Island, GA 31522**.

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New Jersey – Regional CPA firm wishes to acquire or merge with retirement-minded practitioners. Reply to: **Box #195, c/o JOA, P.O. Box 1510, Clearwater, FL 33757-1510**.

Sole practitioners with $1mm revenue in Broward County, Florida seeks to retire via merger or buyout. Reply to: **Box #394, c/o JOA, P.O. Box 1510, Clearwater, FL 33757-1510**. Principals only.

New Hampshire – Lake Sunapee area. CPA grossing $100,000 selling practice. Reply to: **Box #391, c/o JOA, P.O. Box 1510, Clearwater, FL 33757-1510** or email to: **joa@rja-ads.com (Type box number in the subject field)**.

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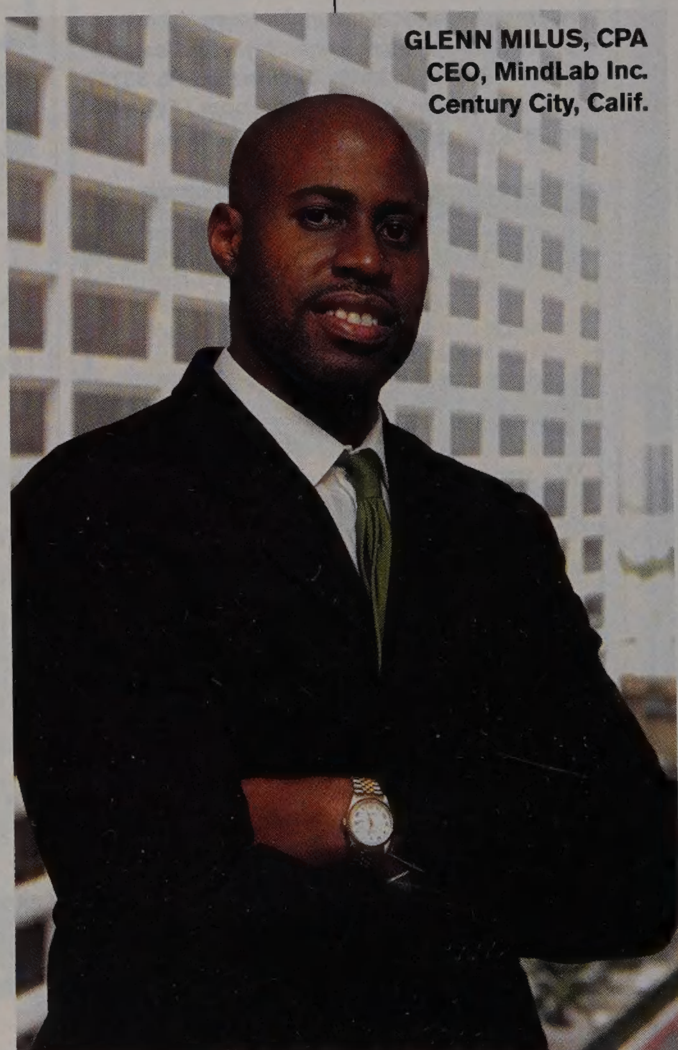
THE LAST WORD

A FRIEND AND I STARTED MINDLAB, a financial management company, about four years ago, though for the first two years I also kept my day job at Honeywell Inc. Our clients include five football players who've been drafted into the NFL, and we expect to sign five more. Many young athletes come from poor and single-parent families, so we try to give them some financial literacy. NFL contracts are not guaranteed and the average career is only 3.5 years. Players make a lot of money in a short window of time, but they also have to pay their agents and pay taxes in every state in which they play. We offer bill payment, revenue and expense monitoring and collection, risk assessment, tax planning and preparation, financial planning and business development services. We help our clients start businesses and write business plans, solicit investors and set up marketing companies for their endorsements.

WE GREW OUR BUSINESS BY AGGRESSIVE NETWORKING. We went to a lot of entertainment functions and passed out cards and beat the pavement. We still go to the college games and hang out in the tunnels and hotel lobbies and stop young athletes and introduce ourselves to them and their parents, and send them literature about how we can add value to their financial lives.



GLENN MILUS, CPA
CEO, MindLab Inc.
Century City, Calif.

I PLAYED ON THE PITTSBURGH PIRATES SCOUTING TEAM IN HIGH SCHOOL. I wanted to be a professional baseball player, but after my son was born I wanted a profession that was more stable. I had a mentor, a CPA named Troy Thrower, who encouraged me to go into public accounting and to get my CPA certification. He told me there's great value in having those letters beside my name.

I WENT TO LOYOLA MARYMOUNT COLLEGE IN L.A., where I was involved in the accounting society and also started the Black Student Business Association. To be honest, you just don't see very many African-American CPAs. I do think it's a great profession, though. There's a particular need and an opportunity for young black CPAs to work with athletes and entertainers, where there is a large client base of African-Americans.

TWO OF THE BIG 5 FIRMS OFFERED ME POSITIONS, but I went to Moss Adams because its partners were coaches of their children's soccer teams and understood the need for a work/life balance. I was the only African-American when I started there, but they went out of their way to make me feel comfortable. I worked in audit and tax, and came to really understand how companies should operate.

I HAD INTENDED TO GET AN MBA DEGREE, so I took a job as a senior financial analyst at Honeywell, which offered a tuition reimbursement program. But shortly after I got there they cut back on that benefit. It was a great experience, though, being in charge of the financial reporting of a $1.5 billion division of a *Fortune* 500 company.

I'M MAKING AS MUCH MONEY AT MINDLAB AS I MADE AT HONEYWELL. Our entertainment-industry clients generally pay us 5% of their revenue year-round. Then we have the NFL players on monthly retainers for the 17 weeks of football season, from August to December, which leads us right up to tax season.

IN THIS BUSINESS THERE'S LITERALLY SOMETHING NEW EVERY DAY. This morning I convinced a football player not to buy a Bentley. He has three cars already and is entering the last year of his contract. So instead of the Bentley, I recommended he get an insurance policy so that if he gets hurt and no team picks him up, he'll still be provided for. Then I worked on a charity event that Gabrielle Union is coming to host, and Access Hollywood and Entertainment Tonight will be there. I'm on the boards of three charities, and I go back to my college once a year to talk about what a great profession accounting is.

—As told to Cheryl Rosen

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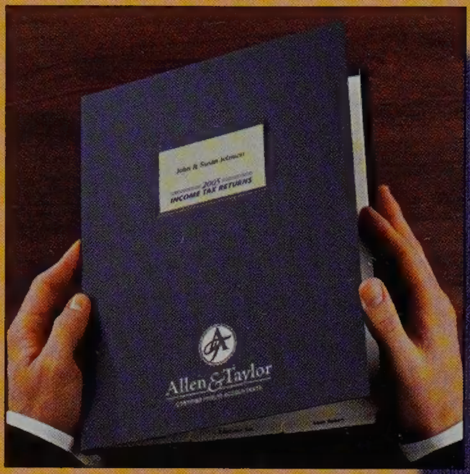

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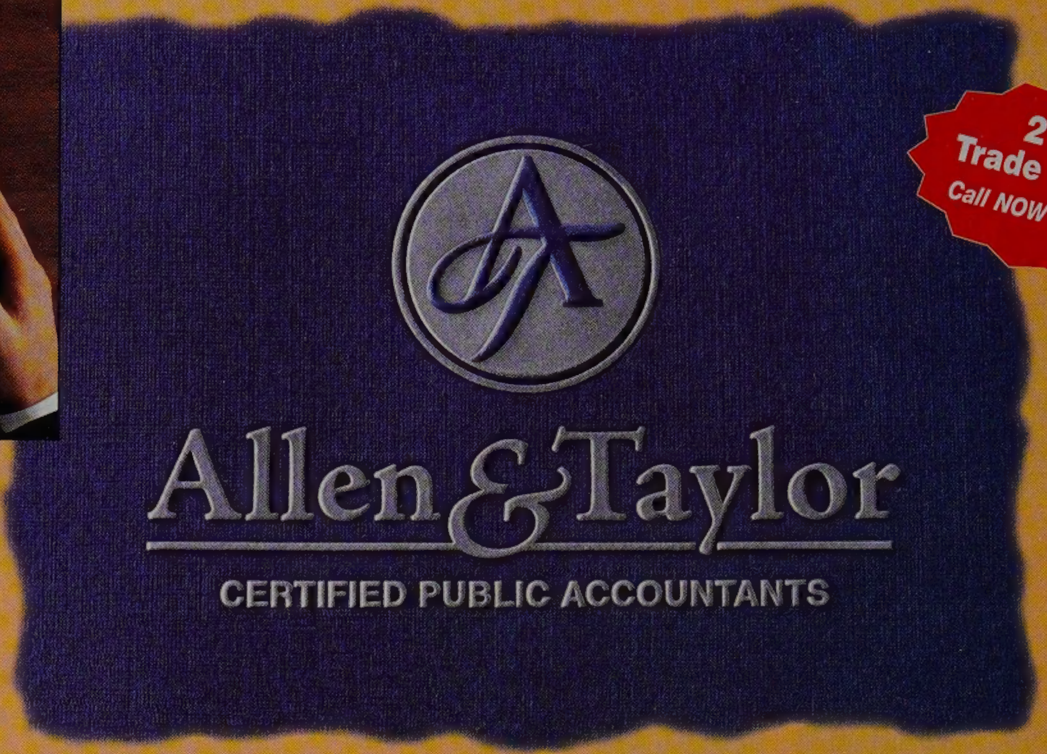

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